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89- 1384

Supreme Court, U.S.
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Supreme Court Of The United States

NO. _____

_____ TERM, 1990

ERNEST ROSS, ET AL.,
Petitioner,
v.

BANK SOUTH, N.A., et al.,
Respondents

GEORGE MILLER, ET AL.,
Petitioner,
v.

ARTHUR M. RICE, JR., et al.,
Respondents

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

ROBERT L. WIGGINS, JR.
(Counsel of Record)
1400 SouthTrust Tower
Birmingham, Alabama 35203
(205) 328-0640

CHARLES CLEVELAND
2326 Highland Avenue South
Birmingham, Alabama 35205

Counsel for Petitioners

105 pp

QUESTIONS PRESENTED FOR REVIEW

1. Where half of a ten member court determines there is a genuine issue of material fact after a careful and detailed review of the evidence but the other half of the court determines there is not, should summary judgment be precluded because the disagreement of the judges, standing alone, demonstrates that reasonable minds differ as to the inferences to be drawn from the record?

2. Where a judge determines that there is a genuine issue of material fact precluding summary judgment under the substantive law as it currently exists, can that judge concur in a finding that there is no such genuine issue merely because he personally disagrees with the state of the law and would like to see it changed?

LIST OF PARTIES

The parties to this case in the Court of Appeals were as follows:

Plaintiffs: Ernest Ross and George Miller, individually and as representatives of a bondholder class.

Developer Defendants: Total Concept Retirement Communities, a joint venture composed of Arthur Rice, Jr. or Wellington Corporation, a corporation owned by Rice; Finerock Corporation, a subsidiary of the underwriter Hereth Orr & Jones, Inc.; and Robinson-Hall, Inc., whose stockholders and officers are Louis Robinson and Richard D. Hall.

Issuer Defendants: The Special Care Facilities Financing Authority of The City of Vestavia Hills, and its Directors William E. Reedy, Claude Otis Brooks, and John C. Burton, and the City of Vestavia Hills, Alabama.

Underwriter Developer: Hereth, Orr & Jones, Inc., its parent Futra Industries, Inc., and its officers and directors Jack Hereth, Peter Orr and Allen O. Jones.

Attorney Defendants: Jones, Bird & Howell, its successor, Alston & Bird, and its partners on September 30, 1981, who were Peter M. Bird, F. M. Bird, Arthur Howell, Eugene T. Branch, Robert L. Foreman, Jr., Frazier Durrett, Jr., Ralph Williams, Jr., Alexander E. Wilson, III, Richard A. Allison, Francis M. Bird, Jr., Rawson Foreman, Ruth H. Gershan, Robert Craft Young, Dow Kirkpatrick, II, Arnold L. Feinstein, Jack S. Schrader, Jr., Michael R. Davis, Alexander E. Wilson, Jr., Earle B. May, Jr., Harriett I. Landau, Kevin E. Grady, William M. Poole, Robert H. Walling, W. Thomas King, William B. Wasson, Joseph W. Crooks, Arthur Howell, III, and Thomas K. Hughes, Jr. They represented the developer, the underwriter, the user and the issuer in connection with the sale of the bonds.

User Defendants: Mount Royal Towers, Inc., was not a defendant because of its bankruptcy, but the number of its Board of Trustees on September 30, 1981 were. They were William V. Weldon, President, James R. Rogers, Vice President, William F. Ogle, Secretary Treasurer, J. H. Blanton, A.

L. Lee, Ida Moffett, John Schuler and R. O. Davidson.

Feasibility Consultant Defendants: Laventhol & Horwath, and some of its past and present partners, directors, and associates: Joan DiMarco, William Frankel, Jim Sherman, Marc Murovitz, Bill Moeckel, Mark Woodward, Aaron Rose and Howard Peters.

Trustee Defendant: BankSouth, N.A.

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OPINIONS BELOW

The decision of the United States District Court for the Northern District of Alabama is reported at 1986 W.L. 2702 and Fed. Sec. L. Rep. Par. 92,526 and the decision of the Court of Appeals for the Eleventh Circuit is reported at 885 F.2d 723 (11th Cir. 1989).

JURISDICTION

The judgment sought to be reviewed was dated and entered on September 18, 1989, but a timely petition for rehearing was not denied until November 16, 1989. This petition for writ of certiorari is being filed within the time extended by this Court after entry of the Eleventh Circuit's judgment. Jurisdiction of this Court is invoked pursuant to 28 U.S.C. Section 1254 (1).

STATUTES AND RULES INVOLVED

The case involves Rule 10(b) (5) of the Securities and Exchange Commission which reads as follows:

> 'It shall be unlawful for any person, directly or indirectly by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (1) To employ any device, scheme, or artifice to defraud,
>
> (2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or;
>
> (3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

> In connection with the purchase or sale of any security.

The case also centers upon the application, meaning and purpose of Federal Rule of Civil Procedure 56 which provides in pertinent part that:

> The judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law.

STATEMENT OF THE CASE

Suit was brought by two bondholders on behalf of a class alleging a fraudulent scheme to issue unmarketable tax except bonds in violation of S.E.C. Rule 10b-5. After certification of a class and substantial, but incomplete, discovery, the district court granted summary judgment for all defendants. The Eleventh Circuit initially reversed the summary judgment, holding that the plaintiffs presented sufficient evidence for a jury to conclude that certain of the defendants[1] engaged in a fraudulent scheme to market unmarketable bonds in violation of Rule 10b-5 (1) and (3). *Ross v. Bank South, N.A.*, 837 F.2d 980, 1004 (11th Cir. 1988). The court below subsequently granted *in banc* review and, by doing so, vacated the decision of the panel which had reversed the summary judgment.

The *in banc* court eventually affirmed the summary judgment on the basis of a sharply divided court, reaching the opposite conclusion of the panel as to whether there was a

[1]The summary judgment was reversed as to the defendant developer, underwriter, feasibility consultant, bond counsel and the parties to the "joint venture", all of whom were found by the Eleventh Circuit panel to be "intimately involved in the development, planning and issuance of these bonds to the public". Ross, *supra*, 837 F.2d at 1004. Dismissal of the remaining defendants was affirmed and no issue about this affirmance is raised in this Petition. *Id.*

genuine issue of material fact regarding the existence of a fraudulent scheme sufficient to make the bonds wholly unmarketable under the Circuit's "fraud-on-the-market" principles of reliance and recovery. *Ross v. Bank South, N.A.*, 885 F.2d 723 (11th Cir. 1989). With ten members sitting on the *in banc* court, only five of them voted that there was a lack of genuine issue of material fact as to the existence of such fraud, while the remaining five voted that there was a such genuine issue of fact. App. 2, 17, 21, 40-68. One of the latter five, however, voted to affirm the grant of summary judgment despite his opinion that there was a sufficient factual controversy to require a jury trial. App. 17, 21 (Tjoflat, J.). Although stating that he found a genuine issue of material fact under the law of the Circuit as it exists, he cast the sixth and deciding vote for affirmance of summary judgment because of his personal belief that the law regarding recovery for "fraud-on-the-market" should be changed. App. 17, 21. The changes he advocated, however, were not adopted by the court below.

There were a plethora of lengthy opinions issued by the *in banc* court. Five of the ten judges concurred in the Opinion of Judge Anderson affirming summary judgment, but three of the five judges joined a concurring opinion that would have changed the law of the Circuit regarding liability for a "fraud-on-the-market". App. 39. (Hill, Fay and Cox, J.). Judge Tjoflat was the sixth judge joining in the result of the opinion of Judge Anderson, and the fourth judge to join in the notion that the law of the Circuit should be changed. App. 17, 21. The remaining four judges joined in the extended dissent of Judge Clark which would have held, along with Judge Tjoflat as the fifth judge, that there was sufficient genuine issue of material fact sufficient to preclude summary judgment. App. 42-68. Three of these dissenting judges also issued their own additional reasons for dissenting. App. 40-42. (Johnson, Kravitch and Hatchett, J.). In total, six judges decided not to change the law of the Circuit, five judges decided there was a genuine issue of material fact under the unchanged law of the Circuit, and five judges decided that there was not such a genuine issue. On this fragmented

basis, the plaintiffs were a denied trial by jury because of facts and factual inferences which even the judges could not agree upon.

A majority of the court below made clear that the "holding of *Shores v. Sklar*, remains the law of this Circuit", and the substantive principles of that holding are the standard against which the sufficiency of the evidence of a fraudulent scheme must be measured for summary judgment purposes in the present case. App. 46-49, 8-10. In *Shores*, the court below held that a plaintiff can recover under Rule 10b (5)(1) and (3), but not under Rule 10b (5) (2), by proving that he purchased bonds that were unmarketable in the absence of fraud even though he did not read the offering statement connected with the bonds. App. 46-49, 8-10. The lack of marketability in the absence of fraud was held to establish causation in such circumstances because if the bonds had not been marketed they could not have been purchased and plaintiffs are permitted to rely upon the integrity of the market not to produce fraudulently marketed bonds. App. 46-49, 8-10.

The plaintiffs' survival of summary judgment thus depends upon the sufficiency of the evidence that in the absence of fraud the bonds would have been unmarketable. App. 46-49. It is the thesis of this Petition that the existence of a genuine issue of material fact is demonstrated by a mere reading of the sharply divided opinions of the court below which, if judges be presumed to be reasonable men, "demonstrate that reasonable minds may differ". App. 40-41. (Kravitch, J.).

STATEMENT OF FACTS

The plaintiff class are purchasers of bonds issued in September, 1981 in the amount of $29,950,000 for a residential facility for the elderly known as Mount Royal Towers in Vestavia Hills, Alabama. The bonds were unmarketable without the appearance of being repayable from the sale of the Mount Royal apartments, which was the sole source of money from which to repay the bonds. Exh. #8, pp. 2, 24-25;

Rice 2nd Depo., pp. 13-14. The bonds could not be issued without certification that 50% of them had been legitimately presold. App. 64-67. In marketing the Mount Royal bonds, the defendants knowingly concealed facts which demonstrated that this precondition to issuance of the bonds had not been legitimately satisfied and which further demonstrated *existing* failures in the sale of the 205 apartments which made default on repayment of the bonds inevitable, specifically: (1) the Mount Royal project had a long history of delay and failure which had "burned the sales territory" and made it virtually impossible to successfully market the apartments, and hence repay the bonds; (2) the original underwriter and feasibility consultant had told the defendants that the apartments were unmarketable and the entire project was infeasible if the sales prices of the apartments were raised any further; (3) the defendants nonetheless doubled the price of the apartments without disclosing that such price increases had been made against the advice of the original underwriter and feasibility consultant; (4) the market for the apartments drastically declined after the sales price of the units were more than doubled; and (5) defendants then resorted to a series of sham transactions and misrepresentations in order to give the appearance of marketability of the apartments and, hence, marketability of the bonds. App. 51-52. The evidence on these points follows.

Efforts to finance the project began in January, 1978 but repeated failures to gain conventional financing occurred. Rice Depo., pp. 137, 241-265, 1000-1003; Exh. #114, p. 253; Pl. Abstract 2. The developer, Art Rice, then turned to the possibility of financing through tax exempt bonds, but he experienced more difficulties and failure there.[2] Exh. #108 and #109, #137, Exh. #114, p. 253; Rice Depo., pp. 392, 394-397, 407, 134-135; Kelly Depo., pp. 117, 119, 123. The City

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[2]Rice formed Mount Royal Towers, Inc. as a non-profit organization to serve as a vehicle to issue the bonds, however, he retained control of it for his personal benefit and profit. Because of misrepresentations of its true nature, the IRS issued a ruling in 1979 that the corporation was exempt from federal taxes as having been organized solely for charitable purposes. Pl. Abstract 8-17.

of Homewood, Alabama refused to sponsor the bonds because of questions about their legality. Exh. #313. Subsequently, however, Rice convinced the City of Vestavia to sponsor the project, first by authorizing Mount Royal Towers, Inc. to issue bonds on behalf of the City and later forming the Special Care Facilities Financing Authority to issue the bonds. Exh. #313, #106; Pl. Abstract 17-19.

Attempts were made to market the bond issue on three different occasions in 1979 and 1980 but they prove unmarketable each time.[3] On December 23, 1980 the Board of Mount Royal passed a Resolution which recited a report by defendant Rice "that reveals the failure, for the second time, of the Bond Issue contemplated to finance the Construction and Development of the Project". Exh. #114, p. 253. (Attached in Appendix). The Resolution also recited that the marketability of the bonds was not expected to change and that the delays in obtaining financing had "negatively impact[ed] the success of the project". *Id.* As a result, one half of the 130 apartments which had been presold had been cancelled by the buyers and the other half were "voided" as a part of the December 23, 1980 Resolution to "abandon the project as of this date". *Id.* and Rice 2nd Depo., pp. 54-55; Rice 1st Depo., pp. 161-162.

Rice, however, stood to lose a substantial personal investment in the project if the bonds were not issued, so he looked for a new set of underwriters, consultants and attorneys to attempt to market the bonds again. Exh. #79; 114, 231; Rice Depo., pp. 654-656. Within a matter of days, Rice had found

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[3]The first marketing of the bonds was in late 1979 by the underwriting firm of Underwood Neuhaus, but the bonds proved unmarketable. Exh. #108, #112 and #114, p. 253; Rice Depo., pp. 392, 394-397, 407, 134-135; Pl. Abstract 6-8. A second attempt to market the bonds was made by the original underwriter in conjunction with another underwriter, Henderson Few and Company, but the bonds continued to be unmarketable despite their best efforts and Underwood Neuhaus withdrew. Exh. #93; Kelly Depo., pp. 146-160; Exh. #109, #137, #114, p. 253; Rice Depo., pp. 392, 394, 407, 134-135. A third attempt at marketing them was made by Henderson Few alone, but failed again. *Id.* and Exh. #63; Pl. Abstract 19-22.

the group that are the defendants in this action.[4] Exh. #66. this action." Exh. #66.

The defendants immediately began to increase the fees, soft costs and other profits to be paid to themselves from the bond issue. *Compare* Exh. #63B, pp. 8 and 27 *with* Exh. #62, p. 3356 and Exh. #387, p. 3192. Based on the increases in soft costs, interest rates and construction costs, the defendants had to raise the already unmarketable bonds from $19,350,000 to $29,950,000. *Id.* The underwriter of that failed bond issue, Henderson Few, and the original feasibility consultant, Peat Marwick, had already determined, however, that the bonds were unmarketable because the sales price of the housing units were set as high as the Birmingham market would bear, but were still inadequate to produce enough revenue to repay bonds carrying sufficient interest rates to be marketable at the 19 million dollar level. Kelley Depo., pp. 146-160, 169; Exh. #109, #137. A formal letter was sent to the defendant developer by Henderson Few on December 5, 1980 which told him that "we [cannot] add significant additional cost to the bond issue budget and still have a feasible financing package". Exh. #109. None of this information was disclosed to the investing public. See Exh. #8.

Nevertheless, the defendants increased the size of the bond issue a month later by 10 million dollars. The increases were necessitated by a 42% increase in the interest rates demanded by the market to make the bonds marketable and a 60% increase in the defendants' fees, profits and other soft costs added to the bonds, all of which were contingent on getting the bonds issue. *Compare* Exh. #63 B *with* Exh. #8.

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[4]By January 6, 1981 Rice had entered a joint venture with the new underwriter and defendant Robinson Hall, which was formed with the assistance of the defendant attorneys. Exh. #66. Thereafter, such attorneys had their hands in virtually every aspect of the Mount Royal project through their simultaneous representation of the underwriters, the issuing authority, the developer, the marketers, and Mount Royal Towers, Inc. itself. Wright Depo., pp. 66-68, 94, 136-137, 170, 200, 366, 382-383, 246-47, 252, 934, 273, 1127, 1134, 1138, 1141, 1266-94; Exh. #78.

Because the bonds were unmarketable without the appearance of being repayable from the sales of the apartments, the prices of the apartments had to be doubled in order to give the appearance of being able to repay the increased bond issue. Kelly Depo., pp. 53-56, 37-38; Rice 1st Depo., pp. 858, 864; Weldon Depo., pp. 206-207; Exh. #66, p. 8, Par. 7.16; Exh. #109. For example, a 1200 square foot apartment priced at $72,900 in December, 1980 was increased to $148,500 two months later. *Compare* Exh. #63B, p. 32 *with* Exh. 8, pp. 15-16 and Exh. #196. See Appendix D to Appellants' Brief before the panel in No. 86-7790 for summary. The "monthly service fees" chargeable *in addition to* the sales price for the same apartment were increased from $996 to $1,542 per month at the same time. *Id.*

The defendants knew that it was infeasible to sell the Mount Royal apartments at the doubled price and occupancy fees and that the bonds were thus doomed to default before they were issued. Pl. Abstract 61-70. This knowledge came from a series of events and facts well known to all the defendants. Even *before* the prices and fees were doubled, the defendants knew that the apartments could not be sold in the Birmingham market. Exh. #11 4, p. 253. The defendants knew that delays and failures in marketing the project over a two to three year period can "burn the sales territory" by giving the purchasing public the impression that the project is shaky or prone to failure. Rice 2nd Depo., pp. 53-54; Exh. #114, p. 254. The Board of Mount Royal Towers formally found in its December 23, 1980 Resolution that this had happened with the Mount Royal project. *Id.* The Resolution stated that virtually all of the pre-sales of apartment units had been cancelled "due to the long delay in construction" and other "negative impacts" on the project. Exh. #114, p. 254. The defendants knew about these failures before they doubled the price of the apartments.[5]

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[5]Peter Wright, the principal witness for the defendant attorney, admits that he knew of the prior failures in marketing the Mount Royal bonds as early as his first meeting with defendant Rice in December, 1980. Wright Depo., pp. 258-259, 392-393, 1150-1151; Exh. #35, p. 2; Exh. #263; Exh. #86, p. 1. Both Wright and his associate, Marietta, also

After the apartment prices and fees were doubled things got worse. Prior to the doubling of the prices and fees the defendants had pre-sold as many as 130 units with average deposits of $1,500 per apartment, but as of April 1, 1981, which was the defendants' original date for closing the bond issue, the number of units that were pre-sold had declined to 33 (16%). Exh. #63B, p. 9; #196; Rice 2nd Depo., pp. 54-55; Rice 1st Depo., pp. 161-163, 879; Exh. #93, p. 22; #70, #96. The defendants then had to extend the bond closing date, but by June 1, 1981 they had still sold only 47 units under the new price structure. Exh. #196.

Up to that point in June, 1981 the defendants had insisted on $1,000 deposits to secure an apartment and deem it pre-sold, but when the apartments ceased selling they eliminated the deposit altogether and began declaring them "presold" with no deposits at all. Exh. #196 and #8, p. 18. Rice admitted this was done to give the appearance of meeting the requirement of pre-selling at least 50% of the apartments prior to the bond issue. Rice 2nd Depo., pp. 89-90, 55-56, 61-63. He said "obviously we can get more applicants with no deposit than we could with a deposit". Rice 1st Depo., p. 927.

In order for a unit to be legitimately considered "pre-sold", however, it must be secured by a deposit of $1,500 with at least $1,000 of it nonrefundable. Kelly Depo., pp. 78-94, 191, 196, 217-220, 222, 224; Exh. #63B, p. 9. None of the units deemed "pre-sold" by the defendants met these conditions.

The requirement of having pre-sold at least 50% of the apartments before marketing the bonds was the primary means of demonstrating the feasibility of repaying the bonds and was an absolute *essential* to the bonds marketability. App. 64-67. The defendant developer knew that bond purchasers would rely on the representations of having pre-sold

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admitted that they knew that the prior marketing failures were "for the same project" as the one for which the bonds were issued in September, 1981. Wright Depo., pp. 392-393; Marietta Depo., p. 692; Exh. #35, p. 2; Exh. #86, p. 1. In April, 1981, JBH determined that there were no "material" changes between the 1980 Mount Royal project and the 1981 one for which the bonds were eventually issued. Exh. #42.

50% of the apartments as evidence of the feasibility of the project and the likelihood of repayment of the bonds. Rice 2nd Depo., pp. 54-55, 61; Kelly Depo., pp. 196, 78-94; Exh. #147B. Indeed, the defendant underwriter sent a letter to investors which stressed that "at the time of closing of this issue approximately 50% of the units will already be "pre-sold". Exh. #5 to Miller Depo., p. 61.

Even after the defendants eliminated the requirement of *any* deposit and promised potential purchasers that they had a unilateral right to cancel at any time without penalty, the defendants were still unable to sell the apartments at the doubled prices and occupancy fees, so they concocted a series of sham transactions with persons having no bona fide intent or means to purchase an apartment to give the false appearance of having 103 of the 205 apartments pre-sold as promised to investors. Pl. Abstract 42-43. Units were "pre-sold" to the developer's saleswoman, her daughter, the daughter of the developer's personal secretary and many other personal friends of the developer and his employees who eventually cancelled after the bonds were issued. Robinson Depo., pp. 94-124; Exh. #196; Rice 2nd Depo., pp. 94-100, 105. Some of these purported purchasers did not satisfy the minimum age restriction of 65 years old and others obviously lacked sufficient funds to purchase a unit in Mount Royal Towers. Robertson Depo., pp. 94-124; McNutt Depo., pp. 147, 150; Exh. 196, pp. 60, 66; Rice 2nd Depo., p. 101; Rice 1st Depo., p. 875. There were also direct misrepresentations to the prospective purchasers by the developer which invalidated such sales as reliable indicators of marketability of the apartments. Foremost among these was the fact that the prospective purchasers of the housing units were told that the substantial sales price of the units were fully refundable when in fact the right to refund was subordinate to the nearly 30 million dollars in bonds. Robinson Depo., p. 56. Prior to

the closing, Rice warned the other defendants about such misrepresentations. Exh. #303.[6]

These sham "presales" quickly evaporated. Pl. Abstract 45-46. More than one half of the 103 commitments to purchase which were represented in the Offering Statement were cancelled after the bonds were issued. Exh. #164; Rice 1st Depo., pp. 929, 1033-1034. There were 22 cancellations in the first 30 days after the bonds were issued. Exh. #198, p. 10; Exh. #196, pp. 28-103; Robertson Depo., pp. 137-138. Within six months of the issuance of the bonds, the 103 pre-sold units had declined to 35 (17% of the total 205 units). Exh. #161; Rice 1st Depo., pp. 1033-34. Of the 48 units[7] which were pre-sold without any deposits to secure them, *none* of this group ever fulfilled their commitment and actually purchased a unit. Exh. #30 9B. The sudden spate of cancellations in the first 30 days after the bonds were issued was indicative of the sham nature of such pre-sale

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[6]This was accomplished in the indenture for the bond issue, which included the Occupancy Agreement which purchasers would eventually be asked to execute but which was not shown to prospective purchasers until after the bonds were issued. McNutt, Depo., p. 166; Exh. #305; R.1-469, p. 15. The prospective purchasers of the apartments were not told of the subordination of their right to refund of the sales price of the apartments to the superior rights of the bondholders. When they eventually learned this fact, more than one half of the pre-sale purchasers refused to go forward with the purchases and this was one of the principal reasons for the default on the bonds and the bankruptcy of the Mount Royal project. Blanton Depo., p. 56-58; Weldon Depo., p. 253.

[7]Fifteen of the 48 Deposit Agreements were made to appear as if a deposit of $100 had been made under the doubled price structure, but this was a false impression since these were persons who had *forfeited* $100 under the 1980 marketing of the sales units but were asked to sign new Deposit Agreements with the understanding that this previously forfeited $100 would be counted as their deposit and they would not have to pay anything further. Rice 1st Depo., p. 87; Exh. #96. Since the $100 was already lost to these purchasers and could not be recovered, their Deposit Agreements were unsecured by any real financial commitment which was "at risk" if the purchase of the housing unit was not finalized. For this reason, these 15 persons are treated the same as the 33 zero depositions.

agreements when they were first entered. At least one of the defendant underwriter's employees who was *not involved* in the Mount Royal project *prior* to the issuance of the bonds admitted in a letter that the rapid rate of cancellations demonstrated "that many of the pre-sales were not real sales to begin with".[8] Exh. #164.

The closing of the bonds on September 30, 1981 included a contract which required that the defendant developer meet a "schedule of minimum sales progress." Exh. #20, Tab F-9, pp. 1056-1062. The feasibility of repaying the bonds was premised upon the developer meeting the required sales schedule. DiMarco Depo., pp. 414, 405-408; Exh. #147B, p. 2; Exh. #8, Attachment II, p. 45 of Feasibility Study. The developer testified, and the district court found, however, that "he did not intend to meet the schedule set out in the closing documents", and which was attached to the contract he signed. R 1-469, p. 16. Within the first six months after the bonds were issued the developer had fallen substantially behind the minimum sales schedule and he never caught up. *Compare* Exh. #161 *with* Exh. #20, Tab F-9. According to his testimony, the other defendants knew that he had never actually obligated himself to meet the minimum sales schedule set forth in the closing documents of the bond issue and in the attachment to the contract he signed. Rice 1st Depo., pp. 778-779, 782-783; Exh. 20, p. 7-9. *After* the bonds were issued, the developers had the Mount Royal Board relieve them of such contractual obligations. Exh. #160. Prior to the formation of the "joint venture" in January, 1981 the marketing fees were contingent on selling 100% of the apartments, but the defendants removed this restriction before

[8]This employee of the underwriter was Margo Mulick-Rosenthal, the research director of HOJ assigned after the closing of the bonds to monitor the Mount Royal sales. In this capacity she received weekly updates of the marketing status and prepared updates and status reports for use by HOJ. Mulick-Rosenthal Depo., p. 265; Exh. #187. After reviewing the rapid drop in applicants and sales following the bond closing, she concluded in a letter to Rice that cancellations of the pre-sales "only strengthen my belief that many of the pre-sales were not real sales to begin with." Exh. #164.

the bonds were issued. *Compare* Exh. #63B, p. 8 *with* Exh. #8, p. 11.

The district court specifically found that "there is little dispute that the defendants attempted to pre-market units, that their effort was unsuccessful, and that, despite their unsuccessful effort, they closed the issue ....." R 1-469, p. 24. These facts were not disclosed in the Offering Statement or Feasibility Study. Exh. #8, pp. iii, 1-2, 24. Instead, the Offering Statement gives the false impression that the pre-closing marketing program had been a success by stating that "the pre-marketing program has convinced the Company that its unique fee structure can be successfully marketed. ... ." Exhibit #8, p. 25. There was no disclosure within the Official Statement or otherwise which indicated that the extensive marketing program prior to the bond issue was already known to be an abject failure at the time the bonds were issued in September, 1981.[9]

The bonds defaulted without *any* principal having been repaid. The collapse and bankruptcy of the entire project followed swiftly after construction was completed in October, 1983. Rice 1st Depo., p. 60. Within six months Mount Royal

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[9]The named plaintiffs purchased the Mount Royal Bonds in reliance on the integrity of the securities market without reading an Offering Statement associated with such bonds. Ross Depo., pp. 171-173, 176-178, 431-433, 153, 487, 495-496, 346, 434, 149; Miller Depo., pp. 357, 354-355, 79, 83, 91, 249, 339, 264-65, 350-51, 353, 421; Def. Exh. #1, Inter. Ans. #10; Plaintiffs Abstract 59. Neither of the named plaintiffs were provided a copy of the Offering Statement, and plaintiff Ross testified that he did not know that an Offering Statement existed and that if he had known one existed he would have requested and read a copy. Ross Depo., pp. 431-433, 153, 487, 4495-496, 346, 434, 149; Miller Depo., pp. 79, 83, 91, 249, 339, 264-265, 350-351, 353, Def. Exh. #1, Inter. Ans. #10. As a result, the plaintiffs were prevented from directly reading or relying upon the Offering Statement by the defendants' failure to distribute it. *Id.* There is no evidence that defendant distributed the Offering Statement to anyone. Pl. Abstract 59. Instead of conducting his own investigation of the bonds which was beyond his means and ability, plaintiff Ross testified that he relied directly on the integrity of the market to purchase bonds that were "safe" *from fraud* and entitled to be in the marketplace. Ross Depo., pp. 171-173, 176-178, 152-153, 89, 435, 993-994, 25-60, 150, 162-163, 437, 480-81, 505; Def. Exh. #1, Int. Ans. #158, #11, #12.

Towers was in bankruptcy because of a lack of sales of the housing units. Rice 1st Depo., p. 561; Rice 2nd Depo., pp. 13-14. The defendants never achieved bona fide sales of even 50% of the units, much less the 91% necessary to avoid default or the 98% they had represented they would achieve within a year. *Id.*

From September 1981 through September 1983, the defendant underwriter underwrote $120,000,000 in life care bonds, all of which have defaulted. Pl. Abstract 71-74. In addition to the $29,950,000 Mt. Royal Towers bond issue, the defaulted bonds include:

1. $53,170,000 First Mortgage Health Care Facilities Revenue Bonds, dated October 1, 1982, issued by Polk County Industrial Development Authority on October 20, 1982 (Polk County issue).
2. $34,000,000 First Mortgage Health Care Facilities Revenue Bonds, dated August 1, 1983, issued by Volusia County Health Facilities Authority on September 29, 1983 (Volusia County issue) Hereth Depo. pp. 501-02.

In December 1983, the National Association of Securities Dealers, Inc. ordered the defendant underwriters to suspend activities as a broker-dealer member. Hereth Deposition pp. 244-45. Many of the current defendants participated in these other life care bond issues.[10]

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[10]On the Polk County issue, Rice signed the underwriting agreement with HOJ as president of Wellington, and as representative of a new "not-for-profit" Royal Regency Foundation, Inc. Rice Deposition p. 991; Exh #152, #153. As with the Mt. Royal issue, Finerock entered into a joint venture with Rice to pay for the development costs of the Royal Regency project. Rice Deposition p. 994; Exhibit #154. Laventhol prepared the feasibility study. DiMarco Depo. pp 256-260. The bonds have defaulted and most of these defendants have been sued for federal securities fraud in *Sheftelman v. Jones*, 84-472A (N.D. Ga.). On the Volusia County life care issue, HOJ agreed to act as underwriter; Jones was the developer through a new limited partnership; Finerock acted as consultant; JBH's successor, Alston & Bird, acted as counsel to Finerock; and Bank South, N.A. Was indenture trustee. Hereth Depo. pp. 501-02; Wright Depo., pp. 874-875. The bonds have defaulted and most of the current defendants

REASONS FOR GRANTING THE WRIT

There should come a point when well-reasoned disagreement between judges is enough, standing alone, to establish a genuine issue of material fact and preclude summary judgment. The various opinions of the judges below were in direct and detailed conflict with one another and demonstrated that reasonable minds do, in fact, differ over the inferences to be drawn from the record in this case. Five judges decided that there is a genuine issue of material fact precluding summary judgment, and five judges decided there was not.

There is something fundamentally flawed with the Eleventh Circuit's application of summary judgment principles when access to trial by jury is precluded on the basis of a record which causes judges themselves to engage in a sharp debate over the facts and inferences to be drawn from the record. By finding that a genuine issue of material fact does not exist when such a dispute is apparent even among the judges themselves, it became apparent that the five member plurality was really weighing conflicting evidence and resolving disputed factual issues when they decided that there was insufficient evidence of fraudulent marketing of the bonds in this case. Nowhere in the opinion of the court below did it even acknowledge that they were bound to view the evidence, and the inferences drawn from it, in the light most favorable to the non-moving party or resolve all reasonable inferences in their favor. Neither did the plurality acknowledge that there should be restraint in granting summary judgment on a complex record where the principal issue to be decided is one of fraudulent intent.

The need for *certiorari* is particularly strong in the current case because the affirmance of summary judgment was achieved by allowing a judge to join the finding of a lack of genuine issue of material fact even though he found such a genuine issue to really exist but voted against it because he

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have been sued for federal securities fraud. *Anderson v. Bank of the South*, 85-1222 (M.D. Fla.).

personally disagreed with the law of the Circuit.

In such a situation as this, the law and the courts cannot command the public's respect because the summary judgment device has too clearly become an artifice for one judge to apply his own personal views of the law rather than the law as it actually exists, and for five other judges to declare factual issues undisputed when five of their fellow judges have demonstrated the very dispute that is pretended not to exist. The thin veneer of logic of such an Alice-In-Wonderland result is too transparent to be truly accepted by fair minded men as a principled application of the law and summary judgment procedures. Where judges are themselves in disagreement about what facts and inferences can be fairly drawn from the record and that disagreement is well-reasoned and documented, summary judgment should be denied. In that situation, the court's own division and disagreement is the very embodiment of the dispute that is genuinely at issue and the courts cannot pretend otherwise without damaging the respect they enjoy among the public.

ARGUMENT

I. SUMMARY JUDGMENT SHOULD BE PRECLUDED WHERE WELL REASONED DISAGREEMENT AMONG AN EVENLY DIVIDED COURT ESTABLISHES THAT REASONABLE MINDS DO IN FACT DIFFER AS TO THE FACTUAL INFERENCES WHICH CAN BE DRAWN FROM THE RECORD

The result reached by the court below discloses a fundamental flaw in summary judgment proceedings which will promote disrespect for the courts and the rule of law if not corrected. The court below has held that it will find a lack of genuine issue of material fact even where the judges of the court are themselves in dispute about what the facts are. By doing so, the court has necessarily disregarded the principles of summary judgment which prevent it from being an unduly

expansive encroachment of the right to trial by jury guaranteed by the Seventh Amendment. Chief among such principles is that the evidence and inferences "must be viewed in the light most favorable to the party opposing summary judgment", that doubts should be resolved against the moving party and that courts should not weigh or chose among conflicting views of the evidence. *Adickes v. S. H. Kress & Co.*, 398 U.S. 144, 157 (1970); *United States v Diebold, Inc.*, 369 U.S. 654, 655 (1962). Without faithful adherence to these principles, the summary judgment device simply becomes a tool for judges to weigh the evidence and determine the facts which the Seventh Amendment has historically entrusted to a jury.

When the conflicting opinions in the court below are examined, a genuine dispute of material fact becomes immediately apparent from the court's division alone. The judges themselves establish such a dispute by their own sharply reasoned debate over the conflicting inferences which can be drawn from the evidence. This is enough by itself to preclude summary judgment. In *Anderson v. Liberty Lobby, Inc.*, 106 S.Ct. 2505 (1986), this Court held that summary judgment should not be granted "[i]f reasonable minds could differ as to the impact of the evidence". *Id.* at 2511. No better demonstration of a difference between reasonable minds can exist than where half the court demonstrates in a well reasoned opinion that it construes the evidence in a manner which is the exact opposite of that of the other half of the court.[11] As stated by Judge Kravitch in her dissent below, the court's own internal dispute "demonstrates that reasonable minds may differ" as to the inferences which can be drawn from the evidence and this alone is enough to preclude summary judgment. App. 40-41.

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[11]This Petition insists the court below was equally divided on the issue of whether a genuine issue of material fact existed because Judge Tjoflat expressly stated that he "would hold that ... appellants have adduced sufficient evidence to create a genuine issue of material fact". App. 11, 17, 21. He made the fifth of ten judges to so decide. App. 40-67, 17, 21. (Clark, Johnson, Kravitch, Hatchett, and Tjoflat, J.).

A careful comparison of the plurality opinion of the five Judges who found no genuine issue of material fact authored by Judge Anderson with the opinion of the five Judges who found the opposite authored by Judge Clark shows this to be true. Judge Clark thoroughly reviews every bit and piece of the evidence construed by the plurality and demonstrates that it is just as susceptible to the opposite inference as the one drawn by the court. Although the various opinions below are too intricate and detailed to compare point-by-point for present purposes, some of the highlights of the dispute of the equally divided court are enough to show the need for review by *certiorari*.

First, the dissent pointed out that the majority ignored the evidence as a whole which demonstrated the alleged fraudulent marketing scheme in several different ways. App. 50-51. The dissent summarized the facts and inferences which could be drawn from the evidence as a whole in the following way:

> The plaintiffs' central claim is that the defendants marketed the bonds even though they knew or recklessly disregarded the fact that the project could not generate sufficient revenue to repay the debt. The plaintiffs support their claim with numerous facts regarding the defendants' conduct which indicates their knowledge of the project's likelihood of failure.
>
> First, the defendant Rice's previous attempts to acquire financing were unsuccessful because the project was financially infeasible in view of the adverse conditions in the bond market. This fact was known to the other defendants. Second, the defendants ignored the warnings of the original underwriter and feasibility consultant that the project would not generate sufficient revenues to repay the bonds at marketable interest rates. Instead, they agreed to modify the project by increasing both apartment unit prices and bond inter-

> est rates to make the project appear feasible although they knew that the changes would render the apartments too expensive to be sold in the relevant geographic market. Third, the defendants' allegedly knew that Rice's sham pre-sale agreements made the project appear feasible. Fourth, the defendants were aware that long delays in construction of the facility 'burned' the sales territory irreparably damaging consumers' interest in purchasing Mount Royal units. Finally, the defendants were able to market the bonds only because they failed to expose the project's inauspicious background which would have seriously undermined the conclusion in the Official Statement that the project was feasible.
>
> In affirming the district court, the majority concludes that the plaintiffs provided only two categories of evidence to satisfy their burden of proof under *Shores:* (1) the fact that past financing attempts failed; and (2) the unsuccessful pre- marketing program and lack of legitimate presales. The majority concludes that the former is irrelevant and that the latter does not create an inference that the bonds were unmarketable. The majority however simply ignores the permissible alternative inferences that a court must afford this evidence on summary judgment. Viewed in a light most favorable to the plaintiffs, the plaintiffs' evidence collectively supports the plaintiffs' contention that the bonds were unmarketable due to the defendants' fraudulent scheme.

Second, the dissent demonstrated that the proven unmarketability of the bonds on three prior occasions put the defendants on notice about the infeasibility of marketing the bonds as finally structured because the restructed bonds were less desirable and less marketable than the earlier ones

which had already failed. App. 53-63. The majority had drawn the inference that the differences between the bonds as actually issued and the earlier unmarketable bonds was irrelevant because the restructuring of the bonds made them more desirable and more marketable. App. 13. The dissent, however, demonstrated that the opposite inference was just as reasonable, and probably more so. App. 53-63. Through a detailed examination of the evidence on the point, the dissent demonstrated that the majority had merely made a credibility choice between two equally supported inferences. App. 53-63. Although, the courts analysis is too detailed to repeat for present purposes, the following is sufficient to show the error of the impermissible appellate factfinding engaged in by the majority:

> The majority's syllogism is fatally flawed for a number of reasons. First, the two projects had significant differences such as the amount of occupancy fees, the refund policy (which subordinated refunds to bondholders), the number of residential units, the dollar amount and interest rate of the bond issue, and the contingent nature of the defendants' fees'. All of these differences are relevant in determining whether the restructured project was financially feasible. The majority, however, focuses solely on one of these differences (the refund policy) rather than analyzing the collective impact of all the differences. Further, the majority's prepaid rent versus ownership analogy masks the simple fact that the second plan required significant higher up-front and monthly payments and that residents were essentially investing in the capitalization of the Mount Royal project.
>
> Next, the, majority reaches the unwarranted and erroneous conclusion that the restructured project was more 'financially attractive' because of the second project's assertedly more lenient refund policy and similarity to owner-

ship. There is no basis, however, for the conclusion that this refund policy is 'lenient' nor is there support in the record for a finding that prospective residents preferred ownership over renting. Instead, the record and simple economic sense establish that the refund policy actually increased residents' risk of financial loss and adversely affected the feasibility of the project's marketing plan. The majority's conclusion regarding the economic effects of the second project's refund policy are simply unsupported by either economic logic or the evidence in the record.

Finally, the majority completes its unrealistic syllogism with the conclusion that because the second project is preferable to the first project (a false assumption), evidence of prior financing failures are irrelevant in determining whether the second project is feasible. In short, the majority's premise (that the projects are dissimilar) does not support its conclusion (that the prior project's financial infeasibility is irrelevant). A more reasonable conclusion is that the differences between the old and new projects actually *favor* the plaintiffs' theory that the second project was infeasible and the bonds unmarketable. Rather than permitting a trier of fact to decide which inferences to draw from the projects' differences, the majority simply presents its own subjective and erroneous view that the restructured project was preferable to the new one. These types of inferences are for the trier of fact, not a court on summary judgment. App. 54-55.

Third, the court demonstrated in similar detail that the defendants had engaged in sham pre-sales of the apartment units in order to give the fraudulent appearance of being able

to repay the bonds and of meeting the requirement of pre-selling 50% of the apartments which was an *absolute* pre-requisite to issuance of the bonds. App. 63-67. Again the dissents detailed analysis of the evidence on this point is too lengthy to repeat here, but the following summary from the dissent is sufficient to demonstrate the error of the majority on this subject:

> The majority misses the mark in concluding that the marketing program's failure to attain 50% legitimate pre-sales does not support an inference of unmarketability.
>
> Thus, Kelley's testimony establishes that the 50% level was the dividing line between marketable and unmarketable bonds. This evidence also establishes that a crucial step in determining the project's feasibility is the number of legitimate pre- sale agreements and the dollar amount of forfeitable pre-sale deposits. These two factors provide the foundation upon which the feasibility of the entire project rests. The underwriting process relies heavily upon the investigation and conclusions of the financial feasibility consultants. Thus, financial projections built upon inaccurate or fraudulent measures of pre-sale commitments crumble like a house of cards.
>
> The majority concedes that the marketing program was not successful in obtaining 50% legitimate pre-sales with deposits but states that the plaintiffs would 'have to prove that the pre-offering marketing program sufficiently predicted the failure of the project so as to render the bonds unmarketable at any price'. A thorough review of the record establishes that the plaintiffs have met their burden.
>
> First, defendant Laventhol & Horvath's feasibility study specifically states that:
>
> > As of July 8, 1981 approximately 32 percent of the residential units

> had been reserved: *the underwriter intends that the series 1981 Bonds will be issued when approximately 50 percent of the residential units have been reserved.*

Laventhol & Horvath, Feasibility Study, at 45. The feasibility study therefore indicates that the 50% pre-sale threshold separated marketable from unmarketable bonds. In addition, Kelley's deposition testimony repeatedly affirms that 50% legitimate pre-sales was a minimum marketability standard. It is difficult to imagine more probative evidence of a bond issue's unmarketability than statements by a project's developer, underwriter, or feasibility consultant that 50% legitimate presales were a marketability litmus test.

Further, the majority's statements that the bonds 'sold' despite disclosure of 'most of the facts' about the pre-marketing program is circular. Had all the facts been disclosed, the project's already precarious financial outlook would be further weakened and the bonds may not have issued. In particular, the fact that the applications without deposits occurred shortly before the bond issue closed provides particularly persuasive evidence that the defendants' attempt to reach the 50% marketability threshold raises a jury issue of fraud.

The majority distinguishes this case from *Shores* because the mispresentations in *Shores* 'went to the concealment of existing factors vital to the viability of the project'. Slip Opinions, at 87, at ___. In contrast, the alleged fraud here 'centers on projections of an uncertain future occurrence, i.e. the sale of the apartments'. *Id.* The majority's distinction, however, simply does not apply in this case

> because the number of legitimate pre-sales is an existing fact upon which the feasibility of the entire project hinged. Kelley's deposition testimony established the fact that issuers and financial feasibility consultants rely upon the existence of legitimate pre-sale agreements and deposits as evidence of a project's marketability. Thus, the number of legitimate pre-sales is certainly 'vital to the viability of the project' in addition to current measures of the market demand for the units.
>
> For all these reasons, the plaintiffs' assertion that Rice engaged in sham pre-sale agreements to make the project appear feasible and the bonds appear marketable creates a genuine issue of fact under *Shores*.

In summary, the opinions of five judges demonstrated in pulverizing detail that there are disputed factual issues requiring trial and that the other five members of the court have simply usurped the jury's role in resolving those disputes. Certiorari should be granted to correct applications of summary judgment which lead to such an anomalous result.

II. SUMMARY JUDGMENT SHOULD NOT BE AFFIRMED WHERE A JUDGE FINDS A GENUINE ISSUE OF MATERIAL FACT UNDER THE LAW AS IT EXISTS BUT REFUSES TO VOTE SUCH CONVICTION BECAUSE HE PERSONALLY DISAGREES WITH SUCH LAW AND WOULD LIKE TO SEE IT OVERTURNED

Without Judge Tjoflat's concurrence in the result, but not the Opinion, of the plurality, the *in banc* Court would have divided five to five on the issue of whether a genuine issue of material fact existed. Judge Tjoflat admitted that "appellants have adduced sufficient evidence to create a genuine

issue of material fact", but he refused to cast his vote in that way because he disagreed with the wisdom of the law of the Circuit regarding liability for "fraud-on-the-market" and thought it should be overturned. App. 17-21. Because he did not join in the plurality's interpretation of the law of the Circuit or gain a majority for his own effort to have it changed, the law remained unchanged.[12] But he still refused to apply that law for reasons of his own *which are not the law.*

The plaintiffs contend that there is a fundamental flaw in this result. In effect, the plaintiffs have been told that they satisfy the law as it exists and established a genuine issue of material fact under such law, but cannot proceed because Judge Tjoflat disagrees with that law. This comes dangerously close to a government of men, not laws. Like everyone on the bench, Judge Tjoflat took an oath to apply the law regardless of his personal beliefs, but his decision in this case raises those beliefs above the law of the Circuit when he expressly states that plaintiffs satisfy the law as it exists but cannot benefit thereby because he disagrees with it.

It would be an altogether different matter if Judge Tjoflat's disagreement with *Shores* had become the law of the circuit, but it did not. Under the law *as it exists,* plaintiffs created a genuine issue of material fact and have a due process right to proceed to the trial by jury guaranteed by the Constitution. They should not be deprived of that merely because a single Judge disagrees with the law and could not gain a majority to join in his disagreement.

Neither should they be deprived of their right to trial by jury merely because five members of a ten member court would interpret *Shores* in a way which leaves no genuine issue of material fact. Those five members' interpretation of *Shores* is also not the law of the Circuit. To take away the right to trial by jury guaranteed by the Seventh Amendment

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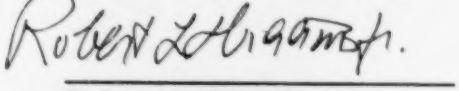
[12] *Trans World Airlines, Inc. v. Harelson,* 432 U.S. 63, 73 n.8, 53 L.Ed.2d 113 (1977) ("Judgment entered by an equally divided Court is not 'entitled to precedential weight"); *Neil v. Biggers,* 409 U.S. 188, 192, 93 S.Ct. 375, 379, 34 L.Ed. 2d 401 (1972); *Smith v. Pyro Min. Co.,* 827 F2d 1081, 1087 (6th Cir. 1987).

on the basis of a five-to-five split as to whether there is a genuine issue of material fact is an implicit denial of that right. The policy considerations which permit summary judgment to interrupt the right to trial by jury are simply too attenuated in this situation causes summary judgment to become a positive denial of that right.

CONCLUSION

The court should: (1) grant the Petition; (2) hold that the Eleventh Circuit's own spirited debate demonstrates a genuine issue of material fact sufficient to preclude summary judgment; (3) hold that Judge Tjoflat's concurrence in a holding that there is no genuine issue of material fact was a nullity once he declared there was, in fact, such a genuine dispute; and (4) remand the case to the district court for trial.

Respectfully submitted,



Robert L. Wiggins, Jr.
Counsel of Record
1400 SouthTrust Tower
Birmingham, Alabama 35203

CERTIFICATE OF SERVICE

This is certify that a copy of the above and foregoing has been served by United States mail, postage prepaid and properly addressed on John E. Grenier, Charles C. Pinckney, Fred J. McCallum, Jr., Lange, Simpson, Robinson and Somerville, 1700 First Alabama Bank Building, Birmingham, Alabama; James H. Gewin, Samuel H. Franklin, Jay D. St. Clair, Bradley, Arant, 1400 Park Place Tower, Birmingham, Alabama 35203; Robert H. Adams, 1804 Seventh Avenue North, Birmingham, Alabama 35203; Kirk M. McAlpin, Jr., Attorney at Law, Peterson, Young, Self and Asselin, Suite 1100, 230 Peachtree Street N.W., Atlanta, Georgia 30303; Robert Wyeth Lee, Jr., Lee and Sullivan, Suite 300, 310 North 2lst Street, Birmingham, Alabama 35203; Michael L. Edwards, Patricia McGee, Attorneys at Law, Blach, Bingham, P.0. Box 306, Birmingham, Alabama 35201; W. Michael Atchison, One Daniel Plaza. Daniel Building, Birmingham, Alabama 35233; Herbert P. Schlanger, Suite 900, 230 Peachtree Street N.W., Atlanta, Georgia 30303; William H. Mills, Redden, Mills and Clark, 940 First Alabama Bank Building, Birmingham, Alabama 35203; and William J. Cobb, H. Marshall Korschun, KOCHER, WILSON, LICHTENSTEIN AND COBB, Attorneys at Law, 1801 Peachtree Road, N.E., Suite 250, Atlanta, Georgia 30309 Atlanta, Georgia 30309; Charles L. Denaburg, Attorney at Law, 2125 Morris Avenue, Birmingham, Alabama 35203; and Mr. Jerre B. Swann, Attorney at Law, KILPATRICK AND CODY, Suite 3100 Equitable Building, 100 Peachtree Street, Atlanta, Georgia 30043.

This the 24th day of February, 1990.

Robert L. Wiggins, Jr.

APPENDIX

Ernest ROSS, individually and as representative of a bondholder class, Plaintiff-Appellee,

v.

BANK SOUTH, N.A., et al., Defendants,

Alston & Bird, et al.,
Defendants-Appellants.

George MILLER, individually and as a representative of a class of bondholders described in the complaint, Plaintiff-Appellee,

v.

Arthur M. RICE, Jr., Defendant,
William V. Weldon, et al.,
Defendants-Appellants.

William V. Weldon, et al., Defendants-Appellants.

Ernest ROSS, individually and as representative of a bondholder class, Plaintiff-Appellants,

v.

BANK SOUTH, N.A., et al., Defendants,

Alston & Bird, et al.,
Defendants-Appellees.

George MILLER, individually and as a representative of bondholder class, Plaintiff-Appellant,

v.

Arthur M. RICE, Jr., et al.,
Defendants-Appellees.

Nos. 86-7350, 86-7790

United States Court of Appeals,
Eleventh Circuit

Sept. 18, 1989

Individual who purchased bonds issued to finance residential and medical facility for elderly brought action alleging developer of project financed by bonds, bond indenture trustee, bond issues, trustees of project, bond underwriter, bond counsel, feasibility consultant, and parties to joint venture formed to develop project, were involved in fraudulent scheme to issue unmarketable tax exempt bonds and that plaintiffs, and class they purported to represent, purchased bonds in reliance on integrity of market. The United States District Court for the Northern District of Alabama, Nos. 85-PT-0444-S, 85-PT-1044-S, Robert B. Propst, J., consolidated actions and certified class, dismissed indenture trustee and issuer defendants, and subsequently dismissed all defendants, and appeal was taken. The Court of Appeals, 837 F.2d 980, affirmed in part, reversed in part and remanded. Panel decision was vacated and hearing en banc ordered. 848 F.2d 1132. Sitting en banc, the Court of Appeals, Anderson, Circuit Judge, held that whether or not fraud on undeveloped market was viable theory, purchasers failed to establish securities fraud violation.

Affirmed.

Tjoflat, Circuit Judge, filed specially concurring opinion.

Hill, Circuit Judge, filed concurring opinion in which Fay and Cox, Circuit Judges, joined.

Kravitch, Johnson, Hatchett, and Clark, Circuit Judges, filed dissenting opinions.

Before RONEY, Chief Judge, TJOFLAT, HILL, FAY, KRAVITCH, JOHNSON, HATCHETT, ANDERSON, CLARK and COX, Circuit Judges.*

ANDERSON, Circuit Judge, with whom RONEY, Chief Judge, and HILL, FAY and COX, Circuit Judges, concur:

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*Judges Vance and Edmondson are recused and did not participate in this decision.

Ernest Ross and George Miller (referred to in this opinion as appellants) sued various parties connected with the issuance of the First Mortgage Residential Facilities Revenue Bond (Mount Royal Towers, Inc. Project) Series 1981 Bonds. In an action based primarily on Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, Ross and Miller claimed the defendants had engaged in a fraudulent scheme to issue the tax-exempt bonds, which would be unmarketable absent the fraud. After certification of a class and substantial discovery, the district court granted summary judgment for the defendants and against the appellants on the securities claims. The appellants appeal from that judgment, and also from the dismissal of their claim based on RICO, see 18 U.S.C. § 1961 *et seq.*, and their various pendent state law claims based on the Alabama Blue Sky Act, Ala. Code §§ 8-6-18, 8-6-19 (1977), Alabama statutory fraud provisions, Ala. Code §§ 6-5-100 to 6-5-104 (1977), negligence and breach of contract.[1] We affirm.

I. BACKGROUND

This case concerns the issuance on September 30, 1981, of bonds with a face value of $29,950,000. The bonds were issued by the defendant Special Care Facilities Financing Authority of the City of Vestavia Hills ("the Authority") to pay for the construction of a residential and medical facility for the elderly. The facility, known as Mount Royal Towers, was to be located in Vestavia Hills, a suburb of Birmingham, Alabama.

The bond issue came at the end of a long series of attempts to finance the project. Originally, the project was to be conventionally financed, but in 1978, Arthur Rice, the developer and a defendant in this action, decided to finance the project through tax-exempt bonds. To this end, Mount Royal Towers, Inc. was incorporated as an Alabama nonprofit corporation. After Rice first contacted another

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[1]The appellants have not asserted on appeal, and thus have abandoned, their claim based on *§17(a) of the Securities Act of 1933, 15 U.S.C.* § 77q(a).

Alabama city about sponsoring the bonds, he approached the defendant City of Vestavia Hills. Vestavia Hills agreed to sponsor the project by forming the Authority and issuing the bonds on behalf of the facility.[2]

Rice then went about setting up the deal. In 1979, he negotiated with the firm of Underwood, Neuhaus to underwrite the bond issue, but in the beginning of 1980 Underwood declined on account of poor conditions in the bond market which hindered marketing even "safe" bonds. After exploring the financing market, Rice then turned to another firm, Henderson, Few & Company, which had been associated with the earlier effort, for a revised bond issue of approximately $19,000,000.

In December of 1980, Henderson, Few & Company decided against underwriting the issue, again due to poor conditions in the market. The plan had contemplated using the bond revenues to construct the project and then using the occupancy fees (i.e., the price of an apartment unit) to repay the bonds. When Rice was advised of Henderson, Few & Company's decision to abandon the underwriting at least temporarily, Rice was also cautioned that the proposed occupancy fees were already as high as the Birmingham market would bear, and that the projected revenue from the fees was insufficient to service bonds with interest rates high enough to be attractive to the bond market. Thus the feasibility of the issue as then structured was called into question. At the end of December, 1980, the defendant Board of Trustees of Mount Royal Towers passed a resolution abandoning the project.

Immediately following the abandonment of the project by Henderson, Few & Company, Rice determined to restructure the deal. At the beginning of 1981, he formed a joint venture, defendant Total Concept Retirement Communities, to act as the developer of the new version of the project. The

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[2]Under Ala. Code § 11-62-1 *et seq.*, public corporations may be organized to assist certain nonprofit organizations in financing the construction of health care facilities. Such a public corporation may make loans to the organization in order to construct the facility and issue revenue bonds payable from the revenue of the loans.

joint venture was composed of a company owned by Rice (the Wellington Corporation), a subsidiary of the new underwriter for the deal, Hereth, Orr & Jones (the Finerock Corporation), and an Atlanta brokerage firm (Robinson-Hall, Inc.). In addition to Hereth, Orr & Jones, a new bond counsel, Jones, Bird & Howell,[3] and a new feasibility consultant, Laventhol & Horwath, were added. Peter Wright, a Jones, Bird attorney, drafted the joint venture agreement. Bank South, N.A., was the indenture trustee. All of these parties were defendants in the action.

Under the previous version of the deal, the occupancy fees ranged from $17,000 to $87,000, depending on the type of apartment. The amount of the bond issue was raised under the new version of the deal from $19,000,000 at 11½% to $29,950,000 at 15% to 17%, reflecting increased interest rates and other costs. To provide repayment of this increased amount, the occupancy fees for the apartments were increased. Thus, under the new plan, the units ranged from $54,000 to $172,000, not including monthly fees for services.

Under the earlier plans the occupancy fee (the major cost of becoming a resident) was only partially refundable if the resident moved within four years and was not refundable at all after four years or if the resident died after one year. Under the new price structure, the entire occupancy fee was to be refundable upon terminating the residency contract or the death of the resident, although the refund was conditioned upon resale of the unit and was subordinated to the bonds.

Marketing efforts for the previous version had begun in January, 1978. From the beginning the project was structured to require "pre-sales" of 50% of the units.[4] By late 1979, there were applications and initial deposits for 135 of the units, but this number began to decline during 1980,

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[3]Alston & Bird, a successor firm of Jones, Bird & Howell, was the defendant in this case.

[4]"Pre-sales" were not completed sales of the apartment units, but rather were indications of interest in the units in the form of applications. Under the previous version of the deal, a "pre-sale" application was accompanied by a $1,500 deposit, of which all but a $100 processing fee was refundable.

reaching approximately half that number at the time the previous version of the deal was abandoned in December 1980. With the restructuring of the project, marketing began anew. Initially, a deposit of $1,000 was required; however, fifteen applicants who had previously applied and had forfeited $100 were not required to make any additional deposit. After falling initially with the increase in prices, the number of units reserved rose from 17% in April, 1981, to 24% in June, to 32% in July. Beginning around this time, no deposit was required to reserve a unit; of the 103 units (50% of the total) which were "pre-sold" at the time of the closing of the bond issue, 15 had applications secured with only the aforesaid $100 and an additional 33 had applications without any deposit at all.

The bonds, in the amount of $29,950,000, were issued on September 30, 1981. The tax-exempt bonds bore interest rates from 15½% to 17%. The official statement for the issue disclosed, *inter alia* the price structure of the units, the status of the marketing program of the facility, and the project's complete reliance for repayment of the bonds on the sales of the apartment. Using the proceeds from the bond issue, Mount Royal Towers was constructed.

However, sales of the apartment units ultimately proved insufficient to sustain the project. On April 15, 1984, Mount Royal filed a petition for reorganization under Chapter 11 and the bonds went into default in September, 1984. Under the reorganization, the facility has continued to operate, and the proceeds of a bankruptcy approved sale have been distributed to the bondholders to partially satisfy the outstanding indebtedness.[5]

Ernest Ross and George Miller each had bought the bonds without seeing the disclosure materials. They brought suit in district court. The cases were consolidated, and a class was certified by order of the district court dated April 8, 1986.

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[5]The appellees emphasize that the bondholders have recouped an amount exceeding the face value of their bonds. In Banc Brief of Apepllees Rice and Wellington at 7. The appeilants dispute this; however, even were the recovery through bankruptcy proceedings to exceed the face amount, that would not automatically foreclose appellants' being able to demonstrate damages.

The class was composed of bondholders who asserted a "fraud on the market" reliance theory and who purchased Mount Royal bonds prior to their default in 1984. After full discovery, the district court on September 18, 1985, granted motions to dismiss in favor of Vestavia Hills and the Authority. The district court converted Bank South's motion to dismiss to a motion for summary judgment, which it granted on December 12, 1985. The district court granted summary judgment in favor of one set of defendants on August 18, 1986, and then entered final judgment against the appellants on October 16, 1986, granting summary judgment in favor of the remaining defendants.

Initially three appeals were consolidated. In No. 86-7350, defendants appealed the April 8, 1986 order certifying the class. In No. 86-7352, Ross and Miller appealed the district court's September 18 and December 12, 1985 orders in favor of Vestavia Hills, the Authority, and Bank South. In No. 86-7790, Ross and Miller appealed the district court order dated October 16, 1986, granting summary judgment in favor of the remaining defendants.

On appeal, a panel of the Eleventh Circuit affirmed the district court's order certifying the class and affirmed the summary judgment in favor of Bank South and the Mount Royal Trustees and the dismissal in favor of Vestavia Hills and the Special Care Facilities Authority. The panel reversed and remanded with regard to the remaining defendants. *Ross v. Bank South, N.A.*, 837 F.2d 980 (11th Cir. 1988). On March 24, 1988, the panel's decision was vacated and rehearing en banc ordered.

Sitting in banc, we now conclude that Ross and Miller have failed to establish their securities law claims against any defendant. We also conclude that the district court did not err in dismissing the RICO claim and did not abuse its discretion in dismissing the pendent state law claims. Thus, the judgment in No. 86-7790 is affirmed. Because we affirm the district court's grant of summary judgment in favor of all defendants on the securities law claim, we need not address the question in No. 86-7350, the appeal of the district court's certification of a class. After the panel opinion, appellants

settled their claims against the Authority (and related parties), Vestavia Hills and Bank South, and appeal No. 86-7352 was dismissed by order of this court on September 19, 1988.[6]

We first address the federal securities law issue, i.e., the fraud on the market theory. We then address the other issues, involving the RICO and state law causes of action.

II. FRAUD ON THE MARKET

The law to be applied in this case is clear. Reliance is an essential element of a cause of action under Rule 10b-5. *See Lipton v. Documation*, 734 F.2d 740, 742 (11th Cir. 1984), *cert. denied*, 469 U.S. 1132, 105 S.Ct. 814, 83 L.Ed.2d 807 (1985). The reliance requirement establishes the causal link between the defendant's activities and the plaintiff's injuries and prevents federal securities law from affording unlimited liability. *Id.* Normally, a Rule 10b-5 plaintiff must therefore show the following: (1) a misstatement or omission, (2) of a material fact, (3) made with scienter, (4) on which the plaintiff relied, (5) that proximately caused his injury. *Huddleston v. Herman & MacLean*, 640 F.2d 534, 543 (5th Cir. Unit A Mar. 1981), *rev'd on other grounds*, 459 U.S. 375, 103 S.Ct. 683, 74 L.Ed.2d 548 (1983).[7] Under certain circumstances, a presumption of reliance may be established where a requirement of actual reliance would make recovery a practical impossibility. Thus, in the case of an omission rather than a misstatement, reliance may be presumed when the plaintiffs could justifiably expect that the defendants would have disclosed the material information. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 92 S.Ct. 1456, 31 L.Ed.2d 741 (1972).

Here, the appellants concede that they did not read the offering documents and thus did not purchase the bonds in

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[6]Because the appellants voluntarily dismissed the appeal in No. 86-7352 and their appeal in No. 86-7790 as to the defendants Bank South, N.A., Vestavia Hills, and the Authority (and related parties), these defendants were not parties to the rehearing en banc.

[7]This case was decided prior to the close of business on September 30, 1981, and is binding precedent under *Bonner v. City of Prichard*, 661 F.2d 1206, 1209 (11th Cir. 1981).

reliance on any material misrepresentation or omission in those documents. In a traditional Rule 10b-5 case, that concession would be sufficient to justify dismissal. However, Ross and Miller invoke the version of the "fraud on the market" theory established by the former Fifth Circuit in *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981) (en banc), *cert. denied*, 459 U.S. 1102, 103 S.Ct. 722, 74 L.Ed.2d 949 (1983). In *Shores*, the court delineated a cause of action based on Rule 10b-5 applicable where the plaintiff has not relied directly on misrepresentations or omissions in the relevant disclosure materials.[8]

In *Shores*, the plaintiff, Bishop, alleged a pervasive scheme by participants in the issuance of a series of industrial revenue bonds to fraudulently induce the public to buy the otherwise unmarketable bonds. The bonds went into default and Bishop brought a class action suit on behalf of the bondholders. Although Bishop, in making out a case under Rule 10b-5, alleged that the issue's offering circular contained misrepresentations, he admitted that he had never read the circular and had bought the bonds on his broker's general recommendation. Citing lack of reliance, the district court dismissed the claim.

The en banc court reversed. It held that, despite Bishop's failure to read the offering circular, he did state a cause of action under Rule 10b-5, specifically 10b-5(a) and (c).[9] While

[8]*Shores* established the fraud on the market theory with respect to the *issuance* of securities in an undeveloped or primary market. Preceding *Shores*, the fraud on the market theory had been established with respect to the trading of previously issued securities, i.e., the secondary market. *See, e.g., Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816, 97 S.Ct. 57, 50 L.Ed.2d 75 (1976); *see also Lipton v. Documation, Inc.*, 734 F.2d 740 (11th Cir. 1984), *cert. denied*, 469 U.S. 1132, 105 S.Ct. 814, 83 L.Ed.2d 807 (1985) (adopting *Blackie* fraud on the secondary market theory). The fraud on the market theory with respect to secondary markets was recently reviewed and upheld by the Supreme Court. *See Basic, Inc. v. Levinson*, 485 U.S. 224, 108 S.Ct. 978, 99 L.Ed.2d 194 (1988).

[9]Rule 10b-5 provides:

Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud, ...

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

10b-5(b) refers to misrepresentations and omissions, the language of sections (a) and (c) is broader. Because these actions are aimed at broader fraudulent schemes, the court reasonsed, the lack of reliance on the offering circular, one specific part of the scheme, was not determinative. When the fraud alleged is so pervasive that absent the fraud the bonds could not have been marketed, the reliance element is established by the buyer's reliance on the integrity of the market, i.e., the action of the market to furnish only securities that entitled to be marketed.

Under *Shores*, a plaintiff must show that:

> (1) the defendants knowingly conspired to bring securities onto the market which were not entitled to be marketed, intending to defraud purchasers,
>
> (2) [plaintiff] reasonably relied on the Bonds' availability on the market as an indication of their apparent genuineness, and
>
> (3) as a result of the scheme to defraud, [plaintiff] suffered a loss.

Shores, 647 F.2d at 469-70 (footnote omitted).

The burden imposed by the first element is a substantial one. *Shores* is based on the understanding that although it is reasonable to rely on the market to screen out securities that are so tainted by fraud as to be totally unmarketable, investors cannot be presumed to rely on the primary market to set a price consistent with the appropriate risk. Thus, the *Shores* court defined fraudulently marketed bonds as those that could "not have been offered on the market at any price" absent the fraudulent scheme. *Shores*, 647 F.2d at 464 n. 2; *See Lipton*, 734 F.2d at 747 (reading *Shores* to apply only to situations where *but for* the fraud the securities would not have been marketable). In other words, the fraud must be so pervasive that it goes to the very existence of the bonds and the validity of their presence on the market. If the plaintiff "proves no more than that the bonds would have been offered at a lower price or a higher rate, rather than that they would never have been issued or marketed, he cannot recover." *Shores*, 647 F.2d at 470. Furthermore, consistent

with the principle that the fraud on the market theory does not convert securities law into a form of investor insurance, *Shores* imposes a scienter requirement: the defendant must have *known* the securities could not be marketed and must have brought the securities to market with the intent to defraud.[10]

The defendants urge this court to overrule *Shores* and the fraud on the market theory as applied to primary markets. We decline to do so; we need not address the merits of the defendants' argument on this point,[11] because assuming arguendo that *Shores* reliance is available to the appellants in this case, the district court correctly held that the prima facie case establishing *Shores* reliance was not established. Appellants allege that defendants marketed the bonds even though they knew or recklessly disregarded the fact that the project could not generate sufficient income to repay the debt. In other words, appellants allege that defendants marketed the bonds knowing that they were not marketable. However, we conclude that appellants have failed to establish the first element of the *Shores* presumption because we conclude that appellants have failed to generate a genuine issue of fact as to marketability.[12] Since appellants concede lack of traditional reliance, the summary judgment was appropriate.

Appellants point to two categories of evidence in an effort to satisfy their burden of adducing a reasonable inference that the bonds were not marketable. First, the appellants argue that Rice and the other defendants must have known that the apartments, and thus the bonds, would be unmarketable, because the underwriter in the previous version of the deal advised them that the unit prices were as high as the market would bear, and yet the price per unit eventually was

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[10]While the standard for scienter in *Shores* was expressed in terms of "knowing" and "intending to defraud," the scienter requirement in this circuit for an action under Rule 10b-5 "is satisfied by proof that the defendants acted with severe recklessness." *Broad v. Rockwell International Corp.*, 642 F.2d 929, 961-62 (5th Cir. 1981) (en banc).

[11]Thus, the holding of *Shores v. Sklar* remains the law of this circuit.

[12]Substantial discovery has been afforded appellants, and they have failed "to make a showing sufficient to establish the existence of an element essential to [their] case." *Celotex Corp. v. Catrett*, 477 U.S. 317, 324-25, 106 S.Ct. 2548, 2553, 91 L.Ed.2d 265 (1986).

substantially increased. For purposes of this opinion, we assume that Rice was cautioned, when the previous version was abandoned, that the occupancy fees were already as high as the Birmingham market would bear. However, this caution related only to the deal as then structured. As noted above, the price structures of the two versions of the deal differed substantially with regard to the refundability of the occupancy fees. In the earlier deal the occupancy fee was to be forfeited if the resident moved or died. In contrast, under the deal as finally structured, the occupancy fee was fully refundable with only two conditions: it was refundable only out of the resale proceeds of the unit, and the refund was subordinated to the bondholder's mortgage. In other words, the occupancy fee in the original version was in the nature of a lump sum prepayment of rent for the right to live there until death. By contrast, the occupancy fee under the final version was more in the nature of a purchase price for a fee simple interest (subject to the conditions above mentioned). That difference would obviously warrant a substantial increase in the occupancy fees. Therefore, the caution against increasing the occupancy fee, which was in the context of the previous deal, could not logically apply to the feasibility of the deal under the new pricing structure. Because this evidence generates no reasonable inference regarding the marketability of the final deal, it does not create a genuine issue of material fact. The appellants offered no other evidence that the price of the apartment units under the final version was so high that they were inherently unmarketable.

The appellants' second category of evidence relates to the pre-offering marketing program. They contend that Rice manipulated the pre-sales program to meet the 50% goal and to make it appear that the sale of the apartment units would be successful. Specifically, the appellants allege that Rice engaged in sham[13] pre-sales to friends and relatives, and that other applications would not validly indicate interest in the units because the purchasers were not required to place a deposit.

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[13]*See* note 14, *infra*.

This summary judgment record does contain reasonable inferences that the pre-offering marketing program was not successful in that 50% pre-sales with deposits were not obtained. However, we do not believe that this evidence carries appellants' burden of proof. Appellants would have to prove that the pre-offering marketing program sufficiently predicted the failure of the project so as to render the bonds unmarketable at any price. We conclude that all reasonable inferences favorable to appellants fall considerably short of satisfying this burden. For example, most of the facts about which appellants now complain were actually disclosed in the offering documents without any adverse effect on marketability. The documents disclosed the fact that there were no binding pre-sales, that a certain number of pre-sales had no deposit or a reduced deposit, and that the occupancy fee refund was subordinated to the repayment of the bonds. In other words, the bonds sold — i.e., were marketable — with these facts known.[14] Appellants have adduced no other evidence that the bonds, or the underlying apartment units, were not marketable.[15] We hold that the

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[14]Appellants argue that there is a reasonable inference that 50% pre-sales was essential to marketability, that there is a reasonable inference that this was not reached, and therefore that there is a reasonable inference that the bonds were not marketable. The principal flaw in appellants' argument is the premise that there is a reasonable inference that 50% pre-sales was *essential* to marketability. The only reasonable inference in this record is the repeated deposition testimony to the effect that 50% pre-sales was *satisfactory evidence of the feasibility of the project.* However, that evidence does not reasonably support the inference of the converse, i.e., that anything short of 50% pre-sales would establish that the project was not feasible. Rather, the evidence is that the feasibility consultant, considering the pre-sale marketing program (with its 33 to 48 applications with reduced or no deposit) and considering the other evidence of feasibility, concluded that the project was feasible. There is no evidence that the pre-sale program was so disastrous that it predicted the failure of the project with sufficient clarity to render the bonds unmarketable. The only evidence to support appellants' claim that the pre-sale program was a "sham," other than facts actually disclosed in the offering documents, was the fact that all of the pre-sales with no deposit failed to materialize into actual sales, and the fact that three of the pre-sales were made to employees (and a daughter of an employee) in the developer's office, and that eight more pre-sales were made by the principal saleswoman to persons she referred to in her deposition as dear friends or about whom she otherwise indicated some degree of friendship.

[15]In fact, the feasibility study contained substantial evidence that sale of the apartment units was feasible, and that the bonds were marketable.

deficiencies in the pre-offering marketing program which are reflected in this summary judgment record do not create a reasonable inference that the bonds or the apartment units were unmarketable.[16]

The facts in this case stand in sharp contrast to the pervasive fraud allegedly present in *Shores*. There, to focus on the disclosure alone, the offering statement allegedly omitted a pending SEC action against the principals, mischaracterized one developer as having extensive land holdings, misportrayed another principal as an experienced developer, and incorporated a materially false and misleading financial statement. *See Shores*, 647 F.2d at 465-66. Whereas in *Shores* the misrepresentations went to the concealment of existing factors vital to the viability of the project, here the alleged fraud centers on projections of an uncertain future occurrence, i.e., the sales of the apartments. The fraud alleged here and the reasonable inferences in the summary judgment record do not reach the threshold level required in *Shores*. The appellants have not adduced evidence sufficient to create a genuine issue of fact with regard to the bonds' lack of marketability.[17]

III. OTHER CLAIMS

The appellants also assert violations of RICO and various causes of action under state law. The gravamen of the appellants' complaint with respect to the RICO claim is that the defendants fraudulently sold the bonds. The complaint avers that the required "predicate acts" consisted of each

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[16]Thus, appellants have failed to establish that the bonds *as they were priced* were unmarketable. *A fortiori*, appellants have failed to establish that the bonds were unmarketable at any price.

[17]Appellants also allege that the bonds were unmarketable because their tax-exempt status was fraudulently obtained. We decline to engage in an analysis of appellants' assertions because the possible deficiences with respect to tax-exempt status about which appellants now speculate clearly had no causal connection at all with the marketability of the bonds or apartments or any loss to appellants. The tax-exempt status was evidence by an Internal Revenue Service determination letter, which has not been rescinded or amended. There is no evidence that any bondholder has been taxed on the interest. There is no evidence anyone questioned the tax-exempt status during the relevent time period.

fraudulent sale of the bonds. However, given our dismissal of the appellants' federal securities law claim, and because the only predicate acts alleged by appellants are in the nature of securities fraud claims that require the reliance/causation element which we have found to be lacking, appellants are bereft of any surviving predicate act. Therefore, the dismissal of the RICO claim was not error.

The district court dismissed the pendent state law claims without prejudice on the ground that the alleged misrepresentations would implicate the legal standards of various states and otherwise involved individualized claims and defenses. *See Kirkpatrick v. J.C. Bradford,* 827 F.2d 718, 725 (11th Cir. 1987), *cert. denied sub nom. Paine Webber Group, Inc. v. Parker,* ___ U.S. ___, 108 S.Ct. 1221, 99 L.Ed.2d 421 (1988); *Simon v. Merrill, Lynch,* 482 F.2d 880, 883 (5th Cir. 1973). The district court also ruled that consideration of these claims in conjunction with the federal claims would result in confusion to the jury.

The appellants argue that the dismissal of the state law claims should be reversed because the district court did not discuss whether the state law claims would be time-barred. *See Pharo v. Smith,* 625 F.2d 1226, 1227 (5th Cir. 1980) (remanding when dismissed pendent state law claim time-barred and record unclear as to whether trial court considered this factor). The district court, in deciding whether to dismiss pendent state law claims, should consider whether a plaintiff's state law claims will be time-barred if dismissed, although this is not a determinative factor. *Id.* However, the appellants did not point out to the district court at the time of dismissal that the claims would be time-barred. In fact, appellants' briefs on appeal do not represent that the claims were actually time-barred at the time of dismissal. Therefore, the district court did not abuse its discretion, and there is no need for remand on this issue.

IV. CONCLUSION

In order to invoke, the *Shores* presumption of reliance, plaintiffs must overcome what the *Shores* court intended to be a high threshold. Because the evidence offered by the

appellants does not create a genuine issue of material fact with regard to the marketability of the bonds, summary judgment was appropriate. Likewise, there was no error in the dismissal of the RICO and pendent state law claims. Therefore, we affirm the judgment in favor of all of the defendants.

AFFIRMED.

TJOFLAT, Circuit Judge, specially concurring:

In *Shores v. Sklar*, 647 F.2d 462 (5th Cir. May 1981) (en banc), *cert. denied*, 459 U.S. 1102, 103 S.Ct. 722, 74 L.Ed.2d 949 (1983),[1] the former Fifth Circuit held that when a pervasive scheme of fraud has resulted in the issuance of unmarketable securities, a plaintiff can satisfy the reliance requirement under Rule 10b-5, 17 C.F.R. § 240.10b-5 (1988), merely by showing that he relied on the integrity of the market to exclude unmarketable securities. In essence, *Shores* made a Rule 10b-5 plaintiff's burden of proving reliance much lighter. *Shores* also created much confusion[2] and elicited much criticism.[3] We granted rehearing en banc in this case to reconsider the holding in *Shores*.

The majority today affirms the district court's grant of summary judgment in favor of the appellees by finding that the appellants have not met the "substantial" evidentiary burden of *Shores*; therefore, the majority declines to address the validity of the *Shores* holding. *Ante* at 729-30. I concur in

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[1] In *Bonner v. City of Prichard*, 661 F.2d 1206, 1209 (11th Cir. 1981) (en banc), this court adopted as binding precedent all decisions of the former Fifth Circuit handed down prior to October 1, 1981.

[2] *See, e.g., Peil v. Speiser*, 806 F.2d 1154, 1162-63 (3d Cir. 1986); *Ross v. Bank South, N.A.*, No. CV 85-PT-0444-S, mem. op. at 11, 1986 WL 2702 (N.D. Ala. Feb. 25, 1986) ("the court must traipse through bog below and fog above to attempt to arrive at the present status of Eleventh Circuit law").

[3] *See, e.g.*, Fischel, Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities, 38 Bus. Law. 1, 12 (1982) (suggesting that other courts not adopt the holding of *Shores*); Comment, The Fraud on the Market Theory: The Debate Rages On, 27 Duq.L.Rev. 277, 293 (1989) (*Shores* decision "indefensible"); Note, Dredging the *Shores* Doctrine: Trends in the Fraud-on-the-Market Theory in the New Issues Context, 23 Ga.L.Rev. 731, 758-62 (1989); Note, The Fraud-on-the-Market Theory, 95 Harv.L.Rev. 1143, 1157-58 (1982) (rejecting possible rationales for *Shores*).

the result reached by the majority, but I would reach that result by a different route. In my view, the evidence in this case does, in fact, satisfy the requirement of *Shores*. The *Shores* holding, however, is fundamentally flawed and should be overruled. Because the appellants' cause of action is based entirely on *Shores*, I concur only in the result affirming the judgment in favor of the appellees.

Although the majority purports to refrain from directly addressing *Shores*, it adds a substantial gloss to the *Shores* holding and in effect reverses it. I dissented in *Shores* and am still convinced that it was wrongly decided. The majority's reformulation of *Shores* does nothing to enhance my dim view of the *Shores* holding. Whether interpreted correctly or incorrectly, *Shores* has no basis in reason and cannot command the investing community's or the general public's respect. With *Shores*, the former Fifth Circuit, and thus this court, embarked on a path of confusion, and I fear that the majority today only pushes us farther down that path. It is time for this court to reverse its course. I write to explain the need for such a reversal.

This concurrence consists of four parts. In part I, I summarize the salient facts in this case. In part II, I discuss *Shores*, the majority's interpretation of *Shores*, how that interpretation effectively reverses *Shores*, and what I believe to be the correct interpretation. I then show that under this correct interpretation, the appellants have produced sufficient evidence to withstand summary judgment on the issue of marketability.

Having shown that this case presents an appropriate opportunity for reexamining *Shores*, I consider in part III the traditional requirement of reliance in Rule 10b-5 actions and how *Shores* relaxes that requirement. I then discuss why the *Shores* extension of the fraud-on-the-market theory to primary markets for newly issued securities incorrectly relaxes the reliance requirement. I do this by showing (1) that reliance on primary markets is inherently unreasonable; (2) that *Shores* creates serious problems in the context of a jury trial; (3) that the calculation of damages in a *Shores* action is problematic; and (4) that *Shores* arbitrarily punishes

some defrauders while passing over others who might have created even more egregious fraudulent schemes. Finally, in part IV, I address the argument that the doctrine of *stare decisis* should preclude any reevaluation of *Shores*.

I.

This case arose out of the sale of revenue bonds for the purpose of financing the construction of Mount Royal Towers — a residential/medical facility for the elderly, to be located near the City of Vestavia Hills, Alabama. In 1979, appellee Arthur Rice entered into an agreement with the City of Vestavia Hills. Under this agreement, Vestavia Hills was to create a municipal authority for issuing the bonds — Special Care Facilities Financing Authority. The bonds were to be repaid solely from funds generated by the sale of apartments in Mount Royal Towers. Rice sought to retain the services of two firms as underwriters for the bond issue, but both firms found the project too risky in light of sluggish markets for bonds and for similar apartment units. In December 1980, the Mount Royal Towers board of trustees abandoned the project, citing insufficient progress in obtaining pre-sale commitments and in securing conventional financing.

Rice, possibly seeking to protect his personal investment, proceeded with the project. Rice finally succeeded in creating a joint venture (Total Concept Retirement Communities) to develop the project. The venture consisted of Wellington Corporation (owned by Rice), Finerock Corporation (a subsidiary of Herreth, Orr & Jones — the new underwriter), and Robinson-Hall, Inc. (an Atlanta brokerage firm). Rice also secured bond counsel, Jones, Bird & Howell (now Alston & Bird).

The venture essentially required two steps. First, Herreth, Orr & Jones determined that the bond issue should be raised from $18,000,000 to $29,000,000 with a proportional increase in the price of the apartment units. Second, the venture required that fifty percent of the units be pre-sold in order to ensure the success of the bond issuance. By eliminating deposit requirements and selling to friends and

family, Rice managed to secure commitments on fifty percent of the units.

The bonds were issued in September 1981. A disclosure statement pointed out that the bonds were extremely risky and that only the Mount Royal project's income secured repayment. Neither appellee Ernest Ross nor appellee George Miller, the named plaintiffs in this case, read the disclosure statement prior to purchasing the bonds. In April 1984, Mount Royal filed for Chapter 11 reorganization. In October 1985, after a bankruptcy sale of the Mount Royal complex, the bondholders received $18,000,000 in satisfaction of the outstanding balance.

The district court granted summary judgment in favor of all defendants. A panel of this court affirmed with regard to Bank South (the indenture trustee), the City of Vestavia Hills, Special Care Facilities Financing Authority, and the Mount Royal trustees. *Ross v. Bank South, N.A.*, 837 F.2d 980, 1003-04 (11th Cir. 1988). The panel reversed the district court, however, with regard to the remaining defendants — Rice, the underwriter, the bond counsel, the feasibility consultant, and the joint venture ("the appellees").[4] Because no challenge was made on appeal to the dismissal of Bank South, the issuing defendants, or the Mount Royal trustees, the only question before this court is whether to affirm the district court's grant of summary judgment in favor of the appellees.

II.

A.

Shores arose out of the sale of tax-exempt revenue bonds for the construction of a facility to manufacture mobile homes in Frisco City, Alabama. Neither the manufacturer who was to use the completed facility nor the underwriter of the bonds was financially secure or experienced in projects of this sort. They managed, however, to induce Frisco City to create an Industrial Development Board for the purpose of

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[4]Hereinafter, all remaining defendants, for the sake of simplicity, will be referred to collectively as "the appellees," unless otherwise specified.

issuing tax-exempt bonds, the proceeds of which would be used to build the facility. The Board would then lease the facility to the manufacturer and use the lease proceeds to satisfy the bond obligations. The offering circular that was issued omitted and misrepresented a number of crucial facts. For example, the circular failed to mention the SEC investigation of the underwriter for violations of the securities laws and misrepresented the qualifications and assets of the manufacturer. *Shores*, 647 F.2d at 465-66.

When the bonds were ultimately marketed, the plaintiff in *Shores* bought four of them. When he purchased them, he neither saw the offering circular nor knew that one existed; rather he relied on his broker's assurances. *Id.* at 467. A little over a year after his purchase, the manufacturer defaulted on his lease of the facility. The plaintiff consequently sought relief under the Securities Act of 1933, 15 U.S.C. § 77a *et seq.* (1982), the Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq.* (1982), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (1988). The district court dismissed his suit because he did not, and could not, allege any reliance on the offering materials.

The former Fifth Circuit, sitting en banc, held that Rule 10b-5(b)[5] required proof of actual reliance on the omissions or misrepresentations in the offering materials but that under subsections (a) and (c) of the Rule, reliance could be implied in certain cases. The court determined that when an offering circular is only one component of a more pervasive fraudulent scheme,

> [t]he requisite element of causation in fact would be established if [the plaintiff] proved the scheme was

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[5]Rule 10b-5 provides in relevent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails . . . ,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

Rule 10b-5, § 17 C.F.R. 240.10b-5 (1988).

> intended to and did bring the Bond onto the market fraudulently and proved he relied on the integrity of the offerings of the securities market.

Shores, 647 F.2d at 469.[6] Thus, the court held that to meet his burden of proof in such a case, a plaintiff must show that:

> (1) the defendants knowingly conspired to bring securities onto the market which were not entitled to be marketed, intending to defraud purchasers, (2) [the plaintiff] reasonably relied on the Bonds' availability on the market as an indication of their apparent genuineness, and (3) as a result of the scheme to defraud, he suffered a loss.

Id. at 469-70 (footnote omitted). The court then concluded that the plaintiff had met his burden under the new test.

The majority finds in the instant case that the appellants did not adduce "evidence sufficient to create a genuine issue of fact with regard to the bonds' lack of marketability" and thus did not satisfy the first prong of the *Shores* test. *Ante* at 731. Although I believe that the *Shores* analysis is flawed, the evidence in this case clearly creates a genuine issue of fact with regard to marketability under the *Shores* test.

B.

Marketability, as envisioned by the *Shores* court, is an elusive concept. The court failed to specify whether the marketability test should apply to the securities that were actually issued or to some theoretical security that could be issued at any combination of price and interest rate. If the former interpretation is correct, then we should determine whether, in the absence of fraud, the bonds would have been issued *given the actual price and interest rate at which they were issued.*

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[6] The court justified this expansive protection of investors under Rule 10b-5 by citing the specific language of subsections (a) and (c) and by referring to the securities acts' broad purpose to "protect investors against fraud and . . . to promote ethical standards of honesty and fair dealing." *Shores*, 647 F.2d at 470 (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195, 96 S.Ct. 1375, 1382, 47 L.Ed.2d 668 (1976)).

The majority, however, apparently accepts the latter interpretation; it characterizes an unmarketable bond as one that "could 'not have been offered on the market at *any price*' absent the fraudulent scheme." *Ante* at 729 (quoting *Shores*, 647 F.2d at 464 n. 2) (emphasis added). Thus, the majority today focuses on what I term the *economic* unmarketability of the bonds: could the bonds, because of the enormous risk of nonpayment, have been brought onto the market at any combination of price and interest rate if the true risk of nonpayment had been known?[7] *See ante* at 730-31 (evaluating only facts that relate to risk of nonpayment). Stated this way, one can easily see the error in the majority's approach: no matter how great the risk of nonpayment, a bond can virtually always be sold at some combination of price and interest rate. *See* Fischel, Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities, 38 Bus.Law 1, 12 (1983) ("Virtually all securities will sell for some positive price."). Because a bond creates a legal right to repayment in the future, so long as that right is enforceable, a bond can never be completely worthless — even if a bondholder must become a bankruptcy creditor and seek only the salvage value of the bond.[8] Consequently, the majority today creates a test that in both theory and practice cannot be met and negates any remedial effect that *Shores* might have had.

Correctly interpreted, *Shores* established a test for what I call *factual* unmarketability, which focuses on the bonds as issued. Under this interpretation, a bond is unmarketable if, but for the fraudulent scheme, some "regulatory" entity

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[7]The majority holds that "appellants have failed to establish that the bonds *as they were priced* were unmarketable. *A fortiori*, appellants have failed to establish that the bonds were unmarketable at any price." *Ante* at note 16. Thus, if the proposition that the bonds as they were priced were marketable is correct, then the majority has created a test that is even more conservative than is necessary to deny relief under *Shores*. The majority's test, however, is not merely dicta: the majority explicitly holds that "[a]ppellants would have to prove that the pre-offering marketing program sufficiently predicted the failure of the project so as to render the bonds unmarketable *at any price*." *Ante* slip op. at 86, at 731 (emphasis added). The test does not become dicta simply because the majority does not see this as a close case.

[8]Even bonds in default have a salvage value. *See* L. Gitman, Principles of Managerial Finance 554 tbl. 19.1 (3d ed. 1982).

(whether official or unofficial)[9] would not have allowed the bond to come onto the market *at its actual price and interest rate*. For example, in *Shores*, if the Town of Frisco City had received all relevant information, it presumably never would have created an industrial development board to finance the project. Thus, one can point to an entity that *would have* prevented the issuance of the bonds in *Shores* had all relevant information been available to it. *Cf. Arthur Young & Co. v. United States Dist. Court*, 549 F.2d 686, 695 (9th Cir.) ("the purchaser of an original issue security relies, at least indirectly, on the integrity of the regulatory process and the truth of any representations made to the appropriate agencies and the investors at the time of the original issue"), *cert. denied*, 434 U.S. 829, 98 S.Ct. 109, 54 L.Ed.2d 88 (1977). This is the only reasonable interpretation of the first prong of the *Shores* test: "securities . . . which *were not entitled* to be marketed." 647 F.2d at 469 (emphasis added). Even an extraordinarily risky security is entitled to be marketed; but a security that presumably would never have been issued by an entity but for the fraud is not "entitled" to be on the market.[10]

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[9] *Cf.* 4 A. Bromberg & L. Lowenfels, Securities Fraud & Commodities Fraud § 8.6(652) (1988) ("The concept might be more accurately described as reliance on the market as a monitor.").

[10] The effects of laboring under the faulty economic unmarketability interpretation surfaced in a recent Fifth Circuit decision, *Abell v. Potomac Ins. Co.*, 858 F.2d 1104 (5th Cir. 1988), *cert. denied*, ___ U.S. ___, 109 S.Ct. 3242, 106 L.Ed.2d 589 (1989). In *Abell*, the court faced a situation in which the subject enterprise had valuable assets at the time the bonds were issued. The bondholders made an argument to the court similar to the factual unmarketability interpretation set forth above. The court rejected this argument even though the bondholders persuasively pointed out that the worthlessness of the securities is not required by *Shores*. The court responded to the bondholders by arguing that marketability does not depend on the value of the bonds but rather on the value of the subject enterprise and the promoter's knowledge of that value. According to the court, a bond is unmarketable, even if valuable, when the promoter knows that the enterprise is doomed to fail. As the court stated, "[a]lthough the assets may have added value to the securities, the sham 'business' did not because the promoters never intended to start a legitimate one." *Id.* at 1122. The court then created a new test for unmarketability: whether the promoter knew that the subject *enterprise* was worthless when the securitites were issued. *Id.* at 1122-23; *see also Stinson v. Van Valley Dev. Corp.*, 714 F.Supp. 132, 138 (E.D.Pa. 1989) (applying the *Abell* test).

Thus, the Fifth Circuit, recognizing the defect in economic unmarketability, but refusing to accept factual marketability, has created a test that is completely

In the present case, Rice twice failed to retain an underwriter for the Mount Royal project. When Rice finally was able to retain Herreth, Orr & Jones as underwriters, Rice was required to pre-sell fifty percent of the units as a condition to issuance of the bonds. To this end, Rice not only eliminated the deposit requirement, but also began selling to friends and relatives in sham transactions. Here, as in *Shores*, the bonds were actually issued by a city (Vestavia Hills) and a municipal issuing authority (Special Care Financing Authority). Thus, here, as in *Shores*, one can point to entities that presumably would have prevented the issuance of the bonds had all relevant information been available to them.[11] Consequently, the bonds arguably were not "entitled" to be on the market and hence were unmarketable under *Shores*, 647 F.2d at 469.[12]

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unrelated to protecting investors and that focuses entirely on the intent of the promoter. No precedent of which I am aware makes the promoter's knowledge of his *enterprise*'s worthlessness the gravamen of a Rule 10b-5 complaint. Moreover, I find nothing in *Shores* to warrant this type of inspection.

A short hypothetical illustrates my point. Suppose first that promoter A creates ACorp for the purpose of marketing widgets. ACorp possesses only nominal assets valued at $10. A is 99% certain that ACorp will fail, but is a risk taker. To market ACorp bonds, A misrepresents ACorp's chance of success and its assets to investors. The bondholders receive less than 1% of their investment in bankruptcy.

Suppose now that B creates BCorp for the purpose of marketing widgets. BCorp possesses assets worth $100,000, but B is absolutely certain that BCorp will fail. The bonds issue for $200,000. The bondholders recover 50% of their investment. Under *Abell*'s modification of economic marketability, BCorp bondholders could recover because B had the requisite bad intent, but ACorp bondholders could not recover. This result is nonsensical yet appears to be mandated by *Abell* and appears to be the next destination on the course that the majority charts today.

[11]The panel in this case found that "the evidence presented (at most) an inference that [the issuer] defendants were negligent in their reliance on Rice and several of the other defendants." *Ross*, 837 F.2d at 1003. Thus, one could assume that had these entities actually known of the fraud, the bonds never would have been marketed.

[12]Although I agree with the dissenters' conclusion that the bonds in this case might have been unmarketable, I cannot concur in their interpretation that unmarketability depends solely on "whether there is any combination of price *and* interest rate at which the bonds would have been marketable but for the fraud." *Post*, at 750 (Clark, J., dissenting). The dissenters have merely restated the majority's test.

C.

When determining whether to grant a motion for summary judgment, a court must view the evidence in a light most favorable to the nonmoving party and must resolve all doubtful issues in favor of the nonmovant. *Hinesville Bank v. Pony Express Courier Corp.*, 868 F.2d 1532, 1535 (11th Cir. 1989). Moreover, a court must act with caution in granting such a motion. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 255, 106 S.Ct. 2505, 2513, 91 L.Ed.2d 202 (1986). Given these well-established principles and in light of the correct interpretation of *Shores* stated above, I would hold that, with regard to the marketability of the bonds, appellants have adduced sufficient evidence to create a genuine issue of material fact.[13]

III.

Because the instant case should survive summary judgment under the *Shores* analysis, I now examine the validity of *Shores*, since overruling *Shores* would result in a summary judgment in favor of the appellees anyway. I begin by reviewing the role that reliance has played in Rule 10b-5 actions and then discuss my concerns with the *Shores* court's relaxation of the reliance requirement.

To state a claim under Rule 10b-5, plaintiffs have always been required to prove reliance on a defendant's fraud. The Supreme Court has recently reaffirmed the importance of reliance as an element of a Rule 10b-5 cause of action. *See Basic Inc. v. Levinson*, 485 U.S. 224, ___, 108 S.Ct. 978, 989, 99 L.Ed.2d 194 (1988). Over the years, however, courts have attempted to mitigate the harshness of this requirement in circumstances that make proof of actual reliance virtually impossible. *See, e.g., id.* at ___, 108 S.Ct. at 990; *Affiliated Ute*

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[13]As noted in the text, *Shores* set out a three-part test to determine whether the plaintiff has stated a cause of action. The panel in the instant case and the majority today discuss only the first prong of that test. Because the second and third prongs of the *Shores* test (reasonable reliance and causation) do not appear to be issues in this case, I will assume that the appellants have adduced sufficient evidence to withstand summary judgment on those points.

Citizens v. United States, 406 U.S. 128, 153-54, 92 S.Ct. 1456, 1472, 31 L.Ed.2d 741 (1971). In Rule 10b-5 suits alleging misrepresentation, a plaintiff still must prove actual reliance. *See Shores*, 647 F.2d at 471; *Dupuy v. Dupuy*, 551 F.2d 1005, 1014 (5th Cir.), *cert. denied*, 434 U.S. 911, 98 S.Ct. 312, 54 L.Ed.2d 197 (1977). When a plaintiff has proven a breach of a duty to disclose material information, however, he is not required to prove actual reliance: a rebuttable presumption of reliance arises. *See Affiliated Ute Citizens*, 406 U.S. at 153-54, 92 S.Ct. at 1472.

Many courts now presume reliance on the basis of the fraud-on-the-market theory. The Supreme Court in *Basic* explained that,

> in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business. . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements. . . . The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less signficant than in a case of direct reliance on misrepresentations.

485 U.S. at ___, 108 S.Ct. at 988-89 (quoting *Peil v. Speiser*, 806 F.2d 1154, 1160-61 (3d Cir. 1986)). Thus, most courts now recognize that, in an efficient securities market, competing judgments of knowledgeable buyers and sellers cause the market to reflect an accurate price based on all available information. *See, e.g., Lipton v. Documation, Inc.*, 734 F.2d 740, 748 (11th Cir. 1984), *cert. denied*, 469 U.S. 1132, 105 S.Ct. 814, 83 L.Ed.2d 807 (1985). Consequently, an investor is entitled to rely on the market price of securities and may recover under Rule 10b-5 if fraud has affected that price. *Blackie v. Barrack*, 524 F.2d 891, 907 (9th Cir. 1975), *cert. denied*, 429 U.S. 816, 97 S.Ct. 57, 50 L.Ed.2d 75 (1976).

This brings me back to *Shores*. The *Shores* court, citing *Blackie* and other fraud-on-the-market cases, applied the theory to a fraud that occurred in a *primary* market — one in which the securities had just been issued — despite the fact

that the theory had only been used in cases involving fraud on well-developed markets. Essentially, *Shores* held that Rule 10b-5's reliance requirement was satisfied if an investor relied on the primary market's integrity to prevent the issuance of unmarketable securities. I find the *Shores* extension to be flawed for four reasons: (1) *Shores* encourages a form of reliance that is inherently unreasonable; (2) it creates tremendous practical difficulties at a jury trial; (3) it mandates a damage award that is inconsistent not only with *Shores'* own reasoning, but also with the fundamental policy of the securities acts; and (4) it punishes some defrauders while passing over others who might have created even more egregious fraudulent schemes. I will address each of these concerns in order.

A.

As I noted above, courts have been willing to imply or presume reliance in situations that would make proof of reliance difficult, if not impossible. *See Basic,* 485 U.S. at ___, 108 S.Ct. at 990; *Affiliated Ute,* 406 U.S. at 153-54, 92 S.Ct. at 1472. Courts, however, have always required that a plaintiff's reliance be "justified" or "reasonable." *See* L. Loss, Fundamentals of Securities Regulation 957-58 (2d ed. 1988); *see, e.g., Bruschi v. Brown,* 876 F.2d 1526, 1529 (11th Cir. 1989); *Straub v. Vaisman & Co.,* 540 F.2d 591, 596-98 (3d Cir. 1976). The former Fifth Circuit held that a plaintiff's reliance is reasonable if he did not "intentionally refuse[ ] to investigate 'in disregard of a risk known to him or so obvious that he must be taken to have been aware of it, and so great as to make it highly probable that harm would follow'." *Dupuy,* 551 F.2d at 1020 (quoting W. Prosser, Torts § 34, at 185 (4th ed. 1971)). In other words, the plaintiff must not have been reckless in relying on the market. *See Gower v. Cohn,* 643 F.2d 1146, 1156 (5th Cir. Unit B May 1981); *see also Shores,* 647 F.2d at 470 n. 6. The adoption in many courts of the fraud-on-the-market theory and its presumption of reliance has not eliminated the reasonableness requirement. The *Shores* court, in fact, made reasonableness the second prong of its test. *See supra* note 13.

The fundamental flaw of *Shores*, however, is its failure to recognize what adoption of the fraud-on-the-market theory in a given context implies. Courts applying the theory must presume that investors can *reasonably* rely on the market to set an accurate price. Because all relevant information is accurately taken into account in well-developed markets, and because investigators commonly rely only on market prices in making their investment decisions, courts essentially have determined that investors may reasonably rely on the prices set by well-developed markets. The Third Circuit recognized this presumption of reasonableness in *Zlotnick v. Tie Communications*, 836 F.2d 818 (3d Cir. 1988). In *Zlotnick*, the court correctly noted that the fraud-on-the-market theory raises three presumptions: (1) that the misrepresentation affected the market price, (2) that the purchaser relied on the security's price, and (3) that the reliance was reasonable. 836 F.2d at 822.[14]

Because the fraud-on-the-market theory presumes reasonable reliance, courts must be very careful when applying this theory to markets other than well-developed, secondary markets; a court must closely examine the reasonableness of relying on the market in question. For example, the court in *Cammer v. Bloom*, 711 F.Supp. 1264, 1280-87 (D.N.J. 1989), closely examined the over-the-counter market to determine whether it was an efficient market capable of supporting the fraud-on-the-market presumptions. *See also Stinson v. Van Valley Dev. Corp.*, 714 F.Supp. 132, 137 (E.D.Pa. 1989) (market for new issue does not warrant application of fraud-on-the-market theory). The *Shores* court, however, failed to conduct such an analysis. Instead, the court merely applied the theory to the primary market and added a reasonableness requirement to its three-prong test. Because fraud-on-the-market implies reasonableness, the second prong of the *Shores* test is nonsensical. Moreover, as I discuss next, the presumption of reasonable reliance on the primary market is simply invalid.

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[14]Of course, this presumption can be rebutted by showing that the plaintiff knows of the misrepresentation and has reason to believe that it affected the market price. *Zlotnick*, 836 F.2d at 822.

As I noted above, *Shores* fails to state whether its unmarketability test focuses on the actual bonds issued (factual unmarketability) or on hypothetical bonds that could be issued at any combination of price and interest rate (economic unmarketability). I have shown that the former interpretation is correct, but reliance on a primary market to exclude either type of unmarketable bonds is unreasonable.

1.

Assuming for the moment that a bond could be economically unmarketable, a primary market cannot reasonably be expected to exclude such a bond. The cast of characters in a primary market consists of initial investors and parties involved in an issuance, such as the promoter/corporation, the underwriter, the bond counsel, and the issuer. Obviously, initial investors cannot rely on themselves to police the market for unmarketable bonds. Thus, *Shores* must stand for the proposition that initial investors may reasonably rely on the issuing parties to exclude worthless securities.

Such a proposition is patently without justification.[15] All of the parties involved in an issuance have a significant self-interest in marketing the securities at a price greater than their true value. The promoter/corporation and the issuer (if a separate entity) have an obvious interest in marketing the securities regardless of their true fair market value. Likewise, the bond counsel and underwriter, who are often retained under a contingency fee contract, are interested in marketing the securities at an inflated price. The underwriter in particular, who, like an insurer, can spread the risk of loss among many stock or bond subscriptions, has a reduced incentive to investigate thoroughly the true value of the securities it underwrites. Additionally, to determine when a security is worthless is nearly, if not completely, impossible. Thus, to accept the economic unmarketability interpretation of *Shores*, we must believe that an initial investor may

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[15] *See* Note, The Fraud-on-the-Market Theory, 95 Harv.L.Rev. 1143, 1158 (1982) (finding no justification except general fairness for relying on underwriting process).

reasonably rely on clearly self-interested (perhaps dishonest) parties to make decisions that are at least burdensome and at most economically irrational. I cannot accept this proposition.

2.

Even if we interpret *Shores* to require factual unmarketability, reliance on the primary market to exclude such securities is equally unreasonable. The participants in the primary market remain the same — the initial investors and the parties involved in issuing the securities. Moreover, the issuing parties are subject to the same self-interest; they all might even be parties to the fraudulent scheme. Therefore, to accept the factual unmarketability interpretation of *Shores*, we must believe that an investor may reasonable rely on some participant in the issuance process to prevent fraudulently marketed securities from entering the market at the given price and interest rate.

In my view, such reliance could never be reasonable. Certainly, an investor might reasonably rely on a state regulatory agency to police a market. *See Arthur Young & Co. v. United States Dist. Court*, 549 F.2d 686, 695 (9th Cir.), *cert. denied*, 434 U.S. 829, 98 S.Ct. 109, 54 L.Ed.2d 88 (1977). Also, I recognize that in some cases, such as the present one, we might be able to point to a party who (1) had control over the issuance of the securities, (2) was unaware of the fraudulent scheme, and (3) would have prevented issuance had all relevant information been available. With the aid of hindsight and in-depth discovery, we could conceivably make such a determination. I cannot, however, sanction a rule that would encourage this type of reliance by investors who lack the advantages of hindsight and discovery that we now enjoy. Such reliance would be unreasonable. But this is exactly the sort of reliance that *Shores* encourages.

3.

Whether we adopt the factual or economic unmarketability interpretation, reliance on the primary market to exclude unmarketable securities is simply unreasonable. An investor

who so relies takes a great and obvious risk. *Cf. Dupuy*, 551 F.2d at 1005.[16] *Shores* created a presumption of reliance that is clearly wrong and then created a reasonableness test that can never be met.

B.

Shores also creates serious problems in the context of a jury trial. A hypothetical, although by no means atypical, *Shores* action demonstrates several of these problems.

First, suppose we have an exceedingly eager, but dishonest, entrepreneur named Smith who desires to defraud the investing community by investing worthless bonds. Smith creates a sham corporation and then obtains the services of an underwriter, Jones, and an issuer, the City of Middletown. Jones insists on some type of security for the bonds, and Smith pledges his interest in a producing oil well that he fraudulently represents as being worth $1,000,000, but is actually worth only $20,000. Smith never intends to make a single payment on the bonds.

When the bonds are issued, certain fraudulent statements are made in a circular, but Johnson, an elderly widow who purchases several bonds, does not read the circular or know of its existence. The bonds are issued for $2,000,000, and Johnson invests $100,000 — most of her life's savings. When the first interest payment comes due, the bonds go into default, and Johnson brings suit for damages under *Shores* against Smith and Jones.[17]

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[16] I am not unmindful of the growing jurisprudence on the issue of sophisticated and unsophisticated investors. Many courts now will deny relief under Rule 10b-5 to a plaintiff who is held to a higher standard of care because of her sophistication. *See, e.g., J.H. Cohn & Co. v. American Appraisal Assocs.*, 628 F.2d 994, 998-99 (7th Cir. 1980). *See generally* Fletcher, Sophisticated Investors Under the Federal Securities Laws, 1988 Duke L.J. 1081, 1085-90. One could argue that reliance on a primary market to exclude unmarketable securities is reasonable for an unsophisticated investor, but such an argument is not persuasive. Knowledge that those involved in issuing securities have an interest in successfully issuing unmarketable securities is certainly not within the exclusive domain of the sophisticated investor. The risk of reliance is obvious, and it should be obvious to all investors regardless of their sophistication.

[17] In this hypothetical, I assume that Johnson does not bring suit against the issuer, Middletown, and therefore may not seek rescission as a remedy. As I discuss in the text, *infra* at 24, rescission is available only against the seller of the securities.

Whether a court adopts the economic unmarketability approach, as advocated by the majority today, or the factual unmarketability approach, makes a difference in how the case of *Johnson v. Smith* will evolve. Therefore, I explore both scenarios. Regardless of which approach the court adopts, however, the results will be equally disappointing.

1.

Under an economic unmarketability approach, all cases, notwithstanding today's decision, should survive summary judgment and go to a jury. Johnson will produce expert testimony to the effect that, because the bonds were doomed to default, they were worthless, hence unmarketable. Smith will produce expert testimony that the bonds had a salvage value (in this case, one cent on the dollar) and thus could have been marketed at some combination of price and interest rate. Since a material issue of fact will exist, the jury will be called upon to determine whether the bonds were marketable. Thus, the trial will result in a "battle of the experts."

Once all of the evidence has been adduced at trial, the court will instruct the jury that Johnson can recover only if the jury finds the bonds unmarketable under *Shores*. Using the economic interpretation of unmarketability, the court will direct the jury to find for Johnson only if the bonds were completely worthless when issued and to find for Smith if the bonds had at least *some* value and could have been issued at some combination of price and interest rate.

Now we can see the dilemma faced by the jury. The jury is presented with a case in which the plaintiff invested $100,000 and recovered only $1,000 on that investment — a loss of 99% of the original investment. Johnson, moreover, is a plaintiff who will elicit strong feelings of sympathy from the jury. The jury, however, is being asked to grant or deny relief based on whether the bonds had a value of at least one cent when issued — a wholly fortuitous circumstance in the eyes of the jury. The facts most impressive to the jury will be Smith's "bad" intent and that his scheme caused Johnson to lose 99% of her life savings. That Johnson lost $99,000

rather than $100,000 will be a meaningless distinction to a jury that represents the conscience of the community.

Two results are possible. First, and most likely, the jury might disregard the *Shores* instruction and find for Johnson — in effect taking the law into its own hands. Or, the jury might abide by the *Shores* instruction, contrary to its conscience. This result is just as bad as the first since *Shores* will fail to command the respect of (1) the community, which is being asked to grant or deny relief based on an apparently meaningless distinction; (2) the plaintiff/investor, who will lose his investment unless he can produce an expert to testify that the bonds were worthless; and (3) the person seeking to defraud the community, who can avoid *Shores* liability simply by creating *some* value for the bonds.[18]

2.

If the court interprets *Shores* to require factual unmarketability, the results in this hypothetical case will be equally disappointing. Johnson will produce experts to testify that, had all relevant information been available, some entity would have prevented the issuance of the bonds. Smith will produce experts to testify that every entity that could have prevented the issuance must have known of his scheme. Thus, Smith will argue, the bonds would have been issued even if all relevant information had been available to the entities capable of preventing the bonds from entering the market. The issue of marketability will again go to the jury, and the jury will again be faced with a decision to grant or deny relief based on a fortuitous circumstance. The jury will be most concerned with whether some entity in the issuance process knew of the fraud and would have done something to prevent the fraud had it known.

Consequently, we are faced with the same two possibilities: either the jury will disregard the *Shores* instruction, or it will follow the instruction. Again, the second possibility will create disrespect for the rule of law on the part of the

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[18]As in our hypothetical case, this value can easily be created by securing the bonds with some asset of minimal value.

community, the investor, and the potential defrauder, who now can avoid *Shores* liability by including in his fraudulent scheme all of the entities in the issuance process.

This exploration of how a typical *Shores* action would evolve in the context of a jury trial demonstrates that juries will find the distinctions drawn by *Shores* to be arbitrary and meaningless. Either the jury will effectively eliminate the reliance requirement when its conscience dictates,[19] or the rule of law in this area will lose the respect of both those it seeks to protect and those it seeks to punish.

C.

The calculation of damages under *Shores* also presents serious problems. Not only would this damages calculation likely conflict with other aspects of the decision, but it also would undermine the primary goal of the securities acts — disclosure.

1.

In a Rule 10b-5 action against non-issuing parties, courts may not grant rescission as a remedy. *Huddleston v. Herman & MacLean*, 640 F.2d 534, 554-55 (5th Cir. Unit A Mar. 1981), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375, 103 S.Ct. 683, 74 L.Ed.2d 548 (1983). Rescission is an equitable remedy that restores the parties to a transaction to their status quo ante. *Id.* at 554. Typically, a buyer discovers a seller's fraud, promptly tenders the goods to the seller, and demands the return of his purchase price. The court then orders the seller to return the purchase price and uses its civil contempt power to coerce the seller's compliance with its order. This remedy is available, however, only against parties to a contract — a court may not order rescission in a buyer's action against a defrauding party who is not a party to the contract of sale. *Id.* at 555. Thus, in the context of Rule 10b-5, where buyers often sue parties that are not in privity of contract with the buyer, rescission is unavailable. *Id.* A

[19]This result is particularly likely when the plaintiff, as in our hypothetical case, arouses the sympathy of the jury.

Rule 10b-5 plaintiff who sues non-issuing parties must seek damages instead.

In a typical Rule 10b-5 case, the measure of damages allows for recovery of out-of-pocket losses. A plaintiff can recover for the damages actually and proximately caused by the Rule 10b-5 violation. *See Woods v. Barnett Bank*, 765 F.2d 1004, 1013 (11th Cir. 1985); *Huddleston*, 640 F.2d at 555.

Under the *Shores* analysis, however, determining damages is problematic.[20] *Shores* implicitly holds that an investor is not entitled to rely on the issuance price as an accurate reflection of a security's worth. *See* 647 F.2d at 470. Only when the security is unmarketable can the investor recover damages. If the investor was not entitled to rely on the selling price, however, on what price can he rely in order to determine his out-of-pocket damages?

One response is that the investor has no price on which to rely and that therefore no damages are assessable. Presumably the *Shores* court did not intend such an empty victory for the investor. Another response is that the only price on which the investor can rely is one cent — the minimum value of a marketable security. Again, under *Shores*, this is presumably not an acceptable approach because the damages recoverable would be so nominal as to preclude the bringing of such suits.

The only other measure of damages is one that would allow the investor to recover the security's original purchase price since no other price exists on which to peg the loss. This is also the only one of the three measures that would provide investors sufficient incentive to bring such suits. The anomaly of such a recovery, of course, is that although the investor had no right to rely on the issuance price when he bought the securities, he can recover that full amount if the securities were unmarketable. Moreover, this measure of damages in effect rescinds the contract of sale by awarding the investor the return of his full purchase price — a remedy wholly inappropriate when the defrauding parties were not the sellers of the securities.

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[20] In *Shores*, interestingly, the en banc decision never states what relief the plaintiff was seeking. Because the case was ultimately settled, this issue was never reached.

2.

That the fundamental purpose of the securities acts is to implement a philosophy of full disclosure has become something of a maxim that guides courts in their efforts to construe the acts. *See Basic*, 485 U.S. at ___, 108 S.Ct. at 982. Some jurists have expressed concern that the fraud-on-the-market theory conflicts with this philosophy because it enables investors to prove reliance on fraud contained in public disclosures without having to read those disclosures. *See id.* at ___, 108 S.Ct. at 997-98 (White, J., concurring in part and dissenting in part) (quoting *Shores*, 647 F.2d at 483 (Randall, J., dissenting)). Consequently, they argue that the theory makes disclosure, which Congress deemed so important, meaningless. The *Shores* court, however, claimed that the goal of full disclosure would not be undermined by its extension of fraud-on-the-market to primary markets because, by limiting recovery to instances when unmarketable securities were sold, investors would still have to read public disclosures in order to recover for securities that were marketed at an improper price. 647 F.2d at 470.

Whether the fraud-on-the-market theory, as traditionally applied, undermines the goal of disclosure is not an issue here. The *Shores* extension, however, contrary to the *Shores* court's protestations, clearly does undermine that goal. As discussed above, the only workable measure of damages in a *Shores* action would be the full price paid by the plaintiff for the new issue. That being so, a *Shores* award would simply be the plaintiff's out-of-pocket expenses caused by the fraud — the same measure of damages for a standard Rule 10b-5 recovery based upon actual reliance, *see* L. Loss, Fundamentals of Securities Regulation 967 (2d ed. 1988) (out-of-pocket normally means difference between price paid and value of securities). Thus, under *Shores*, any incentive to read disclosures essentially disappears since plaintiffs would receive the full purchase price for their securities without having to read disclosure information. Furthermore, an investor might rationally seek to avoid reading disclosures in order to preserve a possible claim under *Shores*.

Not only does *Shores* discourage investors from being informed about their investments, it does so in a context that requires investors to be *extremely* well informed. In a well-developed market, market professionals sift through public disclosures for relevant information. *See* Fischel, Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities, 38 Bus.Law. 1, 13 (1982). Their buying and selling then incorporates relevant information into the market price, and a rational investor can rely on that price. *Id.; see also Basic,* 485 U.S. at ___, 108 S.Ct. at 991-92. Because that process has not yet occurred where securities are newly issued, a rational investor in a primary market must personally sift through the disclosures for information relevant to his investment decision. By taking away the incentive for investors to read disclosure documents accompanying newly issued securities, *Shores* encourages irrational behavior by investors and undermines the securities acts' philosophy of full disclosure.[21]

D.

Finally, one could argue that the underlying goal of securities regulation is to promote free and honest securities markets and that *Shores* promotes that goal by attacking a certain type of fraudulent behavior, i.e., the type of behavior that causes unmarketable securities to appear on the market. Punishing this type of behavior only in primary market transactions, however, is arbitrary since sales of unmarketable bonds do not necessarily constitute the most egregious cases of fraud. One could easily characterize the fraudulent sale of bonds worth $100 for $10,000 as more egregious than the sale of bonds worth $0 for $10, although *Shores* punishes only the latter situation.[22] Or, one could

[21]The *Shores* court also attempted to justify its decision by focusing on the protective nature of the securities acts and insisting that such laws should be read broadly. 647 F.2d at 470. I agree with the premise, but I find no reason to concur in a broad reading that makes no economic sense and that actually conflicts with the fundamental purpose of the securities acts.

[22]This hypothetical assumes that an economic unmarketability interpretation applies.

characterize a fraudulent scheme involving an issuer, underwriter, and bond counsel as more egregious than a scheme involving only the issuer. Factual unmarketability requires the existence of at least one honest issuing party to protect the integrity of the market from unmarketable bonds. Thus, *Shores* would likely sanction only the latter scheme. Moreover, although this type of behavior should be deterred, other means of deterrence are available without having to stretch Rule 10b-5 beyond recognition.[23]

E.

In summary, I find no reasons whatsoever in the caselaw, in the policies underlying the securities acts, or in the theoretical underpinnings of corporate finance that justify the *Shores* court's departure from the established proposition that the fraud-on-the-market theory applies only to well-developed markets.

IV.

Finally, I am compelled to address the argument that, while *Shores* is probably bad law, the doctrine of *stare decisis* prevents us from overruling that case today. *See Post* at 746 (Karvitch, J., dissenting). I am certainly mindful of the importance of *stare decisis*: it provides continuity to the law and allows members of society to conform their conduct to the law without risk of surprise in the courthouse. Nevertheless, *stare decisis* is a "principle adherence to the latest decision." *Helvering v. Hallock*, 309 U.S. 106, 119, 60 S.Ct. 444, 451, 84 L.Ed. 604 (1940) (Frankfurter, J.). Obviously, a departure from precedent could impose certain costs on

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[23]For example, defendants such as those in this case might be subject to criminal liability. *See, e.g.*, 15 U.S.C. § 78ff (1982) (authorizing criminal penalties for violations of 1934 Act's provisions); Ala. Code § 8-6-18 (1984) (authorizing criminal penalties for violations of Alabama securities laws). Additionally, in a case such as this, a plaintiff could bring a common law fraud or negligence action against his broker. The broker would then have an incentive to investigate thoroughly the proposed investment and expose any scheme of fraud. Finally, if the broker is involved in a larger fraudulent scheme, the other participants could be held liable under a theory of vicarious liability.

members of a community who have structured their commercial transactions to conform to precedent, but when the costs of following an erroneous precedent outweigh the costs of departing from it, "respect for precedent balks at the perpetuation of error." *United States v. Minnesota*, 113 F.2d 770, 774 (8th Cir. 1940).

I have shown that appellants in the instant case have produced sufficient evidence to withstand summary judgment on the issue of marketability under *Shores*. Marketability being the only disputed issue in this case, appellants have produced sufficient evidence to take their *Shores* claim to the jury. Therefore, the validity of the *Shores* holding is properly before this court, and, sitting en banc, we are obligated to address that issue. The arguments presented in this concurrence conclusively prove, I submit, that *Shores* is not justified by policy concerns or theoretical considerations and presents enormous difficulties at jury trials and in computing damages. Moreover, it erodes the public's respect for the law and confidence in the ability of the courts to fashion fair and meaningful rules and distinctions. In short, *Shores* is bad law.

A venerable jurist has stated that, "[f]ew rules in our time are so well established that they may not be called upon any day to justify their existence as a means adapted to an end." B. Cardozo, The Nature of the Judicial Process 98 (1921). I find no basis for *Shores*' existence and therefore would take this opportunity to depart from that precedent.

HILL, Circuit Judge, concurring in which FAY and COX, Circuit Judges, join:

I concur.

However, I add this note. Note 11 to the text of the court's opinion observes that *Shores v. Sklar*, 647 F.2d 462 remains the law of this circuit. That is not a holding in the sense that we have today endorsed that case; we have realized that we do not have to reach it. The fact that my brother Clark finds it appropriate, in dissent, to argue the facts of this case at some length calls into question our wisdom in dealing with each case on its own facts. If the "fraud on the undeveloped market" idea is not the law, such debates could be prevented.

I do not dissent from the approach we are taking, but had we reached the "undeveloped market" issue head on, I'd prefer that the theory be abandoned. The expression "fraud on an undeveloped market" is a contradiction in terms. It may be translated as, "fraud on a non-existent market." An undeveloped market is less than a twinkle in the issuer's eye. It says no more than "an unwritten book" or "an uncomposed song."

Perhaps the Court will have an occasion to reexamine *Shores v. Sklar* on another day.

KRAVITCH, Circuit Judge, dissenting:

I agree with Judges Johnson, Hatchett, and Clark that the appellants have raised a genuine issue of material fact as to the marketability of the bonds, thereby precluding a grant of summary judgment. I hesitate to add yet another voice to the chorus of opinions in this case; nevertheless, I believe that some further observations are in order.

The majority concludes that the structure of the first proposed bond offering was so different from the final deal offered to the public that a warning as to the feasibility of the original deal "generates no reasonable inference regarding the marketability of the final deal." Maj. op. at 730. Yet, as Judge Hatchett suggests, the very question of whether the structure of the two deals differed so significantly is itself a question of fact, and one as to which the appellants have raised a genuine issue of material fact. The majority opinion and Judge Clark's dissent demonstrate that reasonable minds may differ as to whether the changes between the bond issue as first planned and as finally executed enhanced the marketability of the bond offering. When the facts and the inferences drawn from the facts are disputed, summary judgment is not proper.

Because I believe the district court erred in granting summary judgment for appellees, I must address the question that the majority does not reach — whether we should overrule *Shores*. I believe that principles of *stare decisis* weigh heavily against overruling *Shores*. If the rule adopted in

Shores should be modified, then Congress or the Supreme Court may do so.

Appellees and several *amici* suggest that *Shores* is inconsistent with the Supreme Court's recent decision in *Basic Inc. v. Levinson*, 485 U.S. 224, 108 S.Ct. 978, 99 L.Ed.2d 194 (1988), which relied in part on the efficient market hypothesis to support its application of the fraud-on-the-market theory's rebuttable presumption of reliance in Rule 10b-5 cases. I recognize that *Basic Inc.* involved a well-developed, i.e., "efficient" market, and that *Shores* and the instant appeal involve undeveloped, inefficient markets. I also recognize that the efficient market hypothesis would not justify indirect proof of reliance absent the efficient, developed market. Yet *Basic Inc.* did not adopt the efficient market hypothesis as the law of the land. Although economic theory may provide courts with guidance, and perhaps insight, the science of economics remains as inexact as the "science" of law itself.[1] I would not revisit and overturn prior decisions simply to bring them into conformity with current — and probably passing — economic fashion.

JOHNSON, Circuit Judge, dissenting:

Although I agree with the majority in sustaining the fraud on underdeveloped market framework as set forth in *Shores v. Sklar, et al.*, 647 F.2d 462 (5th Cir. 1981) (en banc), I would hold that summary judgment is inappropriate in this particular case. I join in Judge Clark's thorough discussion of how the admitted unfeasibility of the first proposed bond issue raises a disputed question of material fact to preclude summary judgment, but write separately on the issue of sham pre-sales.

The majority is correct that complete disclosure of all the material facts surrounding the pre-sale of the Mount Royal

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[1] As Justice White noted in *Basic Inc.*,

> while economists' theories which underpin the fraud-on-the-market presumption may have the appeal of mathematical exactitude and scientific certainty, they are — in the end — nothing more than theories which may or may not prove accurate upon further consideration.

108 S.Ct. at 995 (White, J., joined by O'Connor, J., dissenting).

apartment units would have defeated the plaintiffs' argument that the bonds were unmarketable. If bonds were sold after all material facts were made public, it can hardly be said that the bonds were unmarketable based on those disclosed facts. Judge Clark's dissent somewhat finesses the point that disclosure of a set of facts is a valid defense to the claim that the facts disclosed are responsible for the bonds' unmarketability.

That defense, however, is unavailing in this case. The majority fails to note that some material facts were omitted from the official statement. The majority states that "the documents disclosed that there were no binding pre-sales, that a certain number of pre-sales had no deposit or reduced deposit." However, the documents do not show the high percentage of units pre-sold to *relatives and employees at the last moment* in order to meet the 50% minimum pre-sale level. The question of the materiality of these non-disclosures can be evaluated in light of the following question: Had the omitted facts been disclosed, would the market have been substantially more likely to reject the bonds? Given the nature of the pre-sales and the tenuous nature of the financing involved, market rejection of the bonds would have been quite likely. I cannot say as a matter of law that complete disclosure would not have rendered the bonds unmarketable. Therefore, the question of how the market would have reacted to complete disclosure is for the jury. Plaintiffs have succeeded in raising a disputed issue of material fact regarding whether disclosure of the nature of the pre-sales would have undermined the marketability of the bonds.

For the foregoing reasons, I respectfully dissent.

HATCHETT, Circuit Judge, dissenting:

I join in Judge Johnson's dissent and Judge Clark's dissent to the extent that they find a disputed issue of material fact which should have precluded summary judgment based on the relationship between the first and second bond issues.

CLARK, Circuit Judge, dissenting:

I agree that the issue in this case is whether the defendants "engaged in a fraudulent scheme to issue the tax-exempt bonds, which would be unmarketable absent the fraud." I further agree that the defendants had to have reason to know that the bonds were unmarketable in order to be liable to the plaintiffs. I therefore find the majority opinion's legal analysis is generally correct although I disagree on one legal point.[1]

I part with the majority in its conclusion that the defendants had no reason to know that the bonds would most likely go into default. The majority gives only a slight recognition to the symbiotic relationship between the marketability of the bonds and the marketability of the units of the Mount Royal Towers continuing care facility. The majority's analysis of the economic factors that affected the marketability of those units, and therefore the bonds, is thus insufficient and unrealistic. There is no recognition of the economic climate of the late 1970s and early 1980s when the Federal Reserve Bank Open Market Committee, led by Chairman Paul Volcker, constricted the money supply and the prime interest rate rose to twenty-one percent. Finally, the majority fails to grasp the importance of the type of facts that professionals in the underwriting process must collect and analyze in determining whether a bond issue is likely to be successful. Among those facts is that the project was of a specialty type — a convalescent/retirement home with nursing facilities but with considerable more amenities than the typical nursing home.

As will be decribed in detail, the initial Mount Royal Towers project, from which the original underwriters withdrew, proposed a sale of about $19,000,000 in bonds for the construction of a 250 residential unit continuing care facility for the elderly. The project was repeatedly cancelled because of an insufficient demand for the residential units and the adverse economic conditions in the bond market. The defendants nonetheless raised the bond issue to $29,500,000

[1] See *infra* note 7.

and more than doubled the cost of acquiring and occupying a unit. Yet, they had no assurance that there were any bona fide purchasers for the bonds or the units. In fact, most prospective residents cancelled their agreements shortly after the bonds were issued in September 1981 and before the project opened its doors in July 1983. The bonds defaulted and the facility was sold in bankruptcy for approximately $18,000,000 in 1984.

As judges we are ill-equipped to assess whether the project the defendants promoted was marketable. The facts, as expanded in this dissent, lead me to believe that it may well not have been. It is not the function of judges, however, to make such a decision. There is a genuine issue of fact as to whether a reasonable developer and underwriter would have known that this project would fail. For justice to be done in this case, this factual issue must be submitted to a jury. The reasons I believe this to be true are set forth below.

I. Legal Analysis

A. Rule 10b-5 and the *Shores* Test

In 1934, Congress enacted the Securities Exchange Act to remedy abusive practices in the investment industry which had led to reduced investor confidence in the integrity of securities markets. The Act's central purpose is the protection of investors and the promotion of free and honest security markets. The Supreme Court has stated that the securities acts are designed to "protect investors against fraud and . . . to promote ethical standards of honesty and fair dealing." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195, 96 S.Ct. 1375, 1382, 47 L.Ed.2d 668 (1976).

The 1934 Act's key antifraud provisions are section 10(b)[2] and Rule 10(b)-5, which the Security Exchange Commission

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[2]Section 10(b) makes it unlawful for any person to:

> use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j (1981).

promulgated in 1942. The basic purpose of "section 10(b) and Rule 10b-5 and indeed, the Exchange Act, is to protect investors and instill confidence in the securities markets by penalizing unfair dealings." *Sargent v. Genesco, Inc.*, 492 F.2d 750, 760 (5th Cir. 1974); *see Wolfe v. E.F. Hutton & Co., Inc.*, 800 F.2d 1032, 1036 (11th Cir. 1986) (en banc) (act and rule designed to encompass the "infinite varieties of devices that are alien to the 'climate of fair dealing' " Congress sought to create and maintain). The principal means of investor protection are disclosure requirements and civil remedies for fraudulent conduct.

Undobutedly, a principal purpose of the securities laws is to promote the full disclosure of information that furthers informed investment decision-making. This purpose is manifest in Rule 10b-5(b) which makes it unlawful to "make any untrue statement of a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." 17 C.F.R. § 240.10b-5(b). If information disclosure was all that was necessary to ensure Congress' goal of honest securities markets, the story would end here because 10b-5(b) would be the panacea Congress sought to solve all abuses in the securities industry.

The securities acts, however, have a much broader reach prohibiting complex fraudulent schemes as well as uncomplicated misrepresentations and omissions. Under Rule 10b-5 it is also unlawful to (a) "employ *any* device, scheme or artifice to defraud"; . . . and (c) "engage in *any* act, practice, or course of business which operates *or would operate* as a fraud or deceit upon *any* person." 17 C.F.R. § 240.10b-5(a) & (c) (emphasis added). In contrast to subsection (b), these subsections contain broard and prophylactic language designed to remedy and prevent *any* fraudulent conduct that harms investors or investors' confidence in securities markets. Courts have refrained from interpreting the broad language of Rule 10b-5 to create limitless liability. Instead, they have constructed "workable limits" to liability which accommodate the interests of investors, the business community, and the public generally. *Herpich v. Wallace*, 430 F.2d 792, 804-05 (5th Cir. 1970).

B. *Shores'* "Fraud on the Market" Theory

A primary example of this judicial accommodation is the "fraud on the market" theory this court enunciated in *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981), *cert. denied*, 459 U.S. 1102, 103 S.Ct. 722, 74 L.Ed.2d 949 (1983), and upon which the plaintiffs in this action rely. Under *Shores*, an investor who purchases a security without reading the relevant disclosure documents may still maintain an action under Rule 10b-5 provided he presents evidence of a fraudulent scheme to defraud investors through the sale of unmarketable securities. *Shores* simply recognizes a legitimate theory for protecting investors from fraudulently marketed securities that supplements the disclosure/non-disclosure theories. Security issuers must therefore consider not only whether their dislosures are accurate and complete but whether the securities they issue are unmarketable.[3]

The foundation of a *Shores* cause of action rests upon the proposition that fraud underlying the issuance of a public offering may be the only reason that the securities were offered on the market at all. In *Shores*, the plaintiff had purchased industrial bonds without reading the disclosure documents. The bonds later defaulted and the plaintiff alleged under Rule 10b-5 that the defendants had fraudulently marketed the bonds through the issuance of a misleading offering circular, erroneous financial statements, and other fraudulent acts. The trial court held that the plaintiff failed to establish reliance because of his failure to read the documents. The Fifth Circuit, en banc, affirmed the district court's analysis under 10b-5(b) but held that the plaintiff stated a cause of action under the broader protections of 10b-5(a) and (c). 647 F.2d at 469.

The court held that the fraudulent scheme on the part of the developer, bond counsel, underwriter, accountant and indenture trustee constituted an actionable securities law

[3]Stated differently, the disclosure requirements of the securities act are based on the principle that "[p]eople who are forced to undress in public will presumably pay some attention to their figures." L. Loss, Fundamentals of Securities Regulation, 33 (1988). *Shores* simply recognizes that there are some figures no amount of reconstructive surgery can salvage.

violation despite the plaintiff's admitted non-reliance on the disclosure documents. The court announced a three-part test which requires the plaintiffs to prove that:

> (1) the defendants knowingly conspired to bring securities onto the market which were not entitled to be marketed, intending to defraud purchasers;
> (2) the purchasers reasonably relied on the security's availability in the market as an indication of its apparent genuineness; and
> (3) the purchaser suffered a loss as a result of the scheme to defraud.

Shores, 647 F.2d at 469-70. The first element requires proof of a fraudulent scheme in which participants knowingly or recklessly disregarded the fact that the securities they marketed were unmarketable.[4] The participants must have the requisite degree of scienter. The second element is the "fraud on the market" reliance requirement as applied to initial issuance markets.[5] Because this element incorporates a version of the "fraud on the market" reliance theory that the

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[4]In this circuit, "severe recklessness" satisfies the scienter requirement and is actionable under § 10(b). *Woods v. Barnett Bank of Fort Lauderdale*, 765 F.2d 1004, 1010 (11th Cir. 1985); *Broad v. Rockwell Intern. Corp.*, 642 F.2d 929, 961-62 (5th Cir. 1981) (en banc). In *Broad*, the court defined severe recklessness as "those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it." 642 F.2d at 961-62. "Although the *Broad* court used the modifier 'severe' in its characterization of what kind of reckless conduct can satisfy 10b-5 scienter requirement, its definition of severe recklessness is identical to that used by other courts to describe what conduct they considered reckless." *Woods*, 765 F.2d at 1010 n. 9.

[5]The "fraud on the market" theory:

> is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements . . . The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.

Basic v. Levinson, 485 U.S. 224, 108 S.Ct. 978, 988-89, 99 L.Ed.2d 194 (1988) (quoting *Peil v. Speiser*, 806 F.2d 1154, 1160-61 (3d Cir. 1986).

Supreme Court recently upheld,[6] courts and commentators generally refer to the entire *Shores* theory of liability as "fraud on the market" theory.[7] Finally, the third element simply establishes damages.

The majority finds that the plaintiffs' burden to prove the first element in a *Shores* action is a "substantial one." Maj. op. at 729. To satisfy their burden under the first element of the *Shores* test, the plaintiffs must establish three facts: the existence of a scheme to defraud, the defendants' knowing participation in the scheme (scienter), and the securities' unmarketability. The majority, however, holds that the plaintiffs have not met their burden because they have "failed to generate a genuine issue of fact as to marketability." Maj. op. at 730. Thus, the majority does not address whether a scheme to defraud existed or whether the defendants' knowingly participated in the scheme. Instead, the majority concludes that evidence of previous failures to raise project financing and the project's unsuccessful marketing program fail to raise a genuine factual issue. As discussed *infra*, the majority opinion unjustifiably eliminates these crucial forms of evidence which determine a security's unmarketability.

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[6]The *Levinson* Court upheld the application of the fraud on the market reliance theory in an action based on material misrepresentation action under Rule 10b-5. The Court held that the theory supports a rebuttable presumption of reliance. 485 U.S. at ___, 108 S.Ct. at 988-91.

[7]The majority misinterprets the *Shores* fraud on the market theory by asserting:

> *Shores* is based on the understanding that although it is reasonable to rely on the market to screen out securities that are so tainted by fraud as to be totally unmarketable, *investors cannot be presumed to rely on the primary market to set a price consistent with the appropriate risk.* Thus, the *Shores* court defined fraudulently marketed bonds as those that could not have been offered on the market at any price."

Maj. op. at 729 (emphasis added. Citations omitted). This interpretation of *Shores*' fraud on the market approach to reliance is inconsistent with *Shores* and *Levinson*. It is precisely because investors rely upon the integrity of the primary market underwriting process to set a non-fraudulent price that *Shores* adopted the "fraud on the market" reliance theory. Thus, there is no support for the majority's novel interpretation of the fraud on the market theory, particularly since the Supreme Court has specifically stated that the theory is derived from the efficient market hypothesis whose principal tenet is that markets set prices based on all currently available information. *Levinson*, 485 U.S. at ___, 108 S.Ct. at 988-92.

The concept of unmarketability in *Shores* requires a factual inquiry into the proposed entity's projected financial viability. Unmarketability under the *Shores* test does not require that the plaintiffs demonstrate the securities they purchased are totally worthless. The plaintiffs *Shores*, for example, received thirty-seven percent of their initial investment. *Shores v. Sklar*, 844 F.2d 1485, 1488 (11th Cir. 1988). Instead, the plaintiffs must prove only that the securities were *unmarketable*. An unmarketable security is one which would not have been issued absent some type of fraudulent conduct by the issuer. *Shores*, 647 F.2d at 474 n. 2; *Lipton v. Documation, Inc.*, 734 F.2d 740, 745 (11th Cir. 1984) (extending fraud-on-the-market reliance theory to open market), *cert. denied sub nom., Peat Marwick Mitchell & Co. v. Lipton*, 469 U.S. 1132, 105 S.Ct. 814, 83 L.Ed.2d 807 (1985). The fraudulent marketing scheme must be "so pervasive that without it the issue would not have issued, the dealer could not have dealt in, and the buyer could not have bought [the bonds], because they would not have been offered on the market at any price." *Shores*, 647 F.2d at 464 n. 2. The phrase "[the bonds] would not have been offered on the market at any price" is imprecise and could lead to the erroneous conclusion, for example, that the bonds in *Shores* would have been marketable at 37 cents on the dollar (the nominal return investors received), rather than face value. The relevant inquiry is whether there is any combination of price *and* interest rate at which the bonds would have been marketable but for the fraud.

Thus, marketability requires a factual showing that the security would not have been issued but for the defendants' knowingly fraudulent conduct. This factual inquiry may be relatively simple in cases where a fraudulent scheme's sole purpose from its inception was to swindle investors. The inquiry, however, becomes more arduous when a project's promoters fraudulently portray an otherwise infeasible project as financially viable in order to issue unmarketable bonds. This latter inquiry is critically dependent upon a thorough review of *all* the evidence relevant to the project's feasibility and the bonds' marektability. For this reason, the

standard of review on summary judgment has increased importance under the *Shores* test.

II. Standard of Review on Summary Judgment

A number of standards determine the scope of review of the district court's order granting summary judgment. First, review of the district court's order is plenary and is conducted using the same legal standards as those used in the district court. *Carlin Communications v. Southern Bell*, 802 F.2d 1352, 1356 (11th Cir. 1986); *Mercantile Bank & Trust v. Fidelity & Deposit Co.*, 750 F.2d 838, 841 (11th Cir. 1985). A *de novo* review of the voluminous evidentiary record in this action, therefore, is required.

Second, the fact that substantial discovery has occurred and that the plaintiffs bear the burden of proving the relevant issues at trial affects the review of the district court's order. A court should grant summary judgment if the plaintiffs fail to make a showing sufficient to establish the existence of an element essential to their case. *Celotex v. Catrett*, 477 U.S. 317, 321-22, 106 S.Ct. 2548, 2552-53, 91 L.Ed.2d 265 (1986). This showing, which need not be in the form of admissible evidence, can be made by reference to affidavits, depositions, and answers to interrogatories. 477 U.S. at 323, 106 S.Ct. at 2553-54. In determining whether the moving party has met his burden, the evidence and inferences drawn from the evidence are viewed in the light most favorable to the nonmoving party, and all justifiable inferences are resolved in his favor. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 253-54, 106 S.Ct. 2505, 2513, 91 L.Ed.2d 202 (1986); *Carlin*, 802 F.2d at 1356. A court may not weigh conflicting evidence to resolve disputed factual issues. Instead, if a genuine issue of material fact is found, the court must deny summary judgment. *Carlin*, 802 F.2d at 1356.

Finally, the complex factual inquiries inherent in a *Shores* cause of action necessitate a restrained approach towards granting summary judgment in favor of defendants. The *Shores* plaintiffs must prove that (1) each defendant acted with scienter; (2) participated in a scheme to defraud the investing public; and (3) that the bonds could not have been

marketed but for the defendants' fraudulent scheme.[8] Each of these fact-bound elements are generally ill-suited for summary review. *Levinson v. Basic Inc.*, 786 F.2d 741, 749 (6th Cir. 1986) (summary judgment inappropriate in section 10(b) security cases), *reversed on other grounds*, 485 U.S. 224, 108 S.Ct. 978, 99 L.Ed.2d 194 (1988); Vol. 10A, Wright, Miller & Kane, Federal Practice and Procedure, Civ.2d § 2732, 309-10 (1983).

In particular, factual questions regarding whether bonds would be marketable absent the defendants' fraud are generally not susceptible to determination as a matter of law. Judicial review of the marketability of the bonds at issue requires the examination of complicated financial documents, feasibility studies, and testimony by financial professionals all of which stretch the judicial ability to conclude with certainty that no genuine issues of fact exist. "The question whether a security was 'entitled to be marketed,' i.e., whether the security, absent the fraud, could have been marketed at some price, and the question whether the scale of fraud was broad enough are both presumably questions of fact, not readily disposed of by summary judgment." *Shores*, 647 F.2d at 486-87 (Randall, J., dissenting). With these standards in mind, we review the plaintiffs' evidence in a light most favorable to their position.

III. Evidence of Marketability of Bond Issue

The plaintiffs' central claim is that the defendants marketed the Mount Royal bonds even though they knew or recklessly disregarded the fact that the project could not generate sufficient revenue to repay the debt. The plaintiffs support their claim with numerous facts regarding the defendants' conduct which indicates their knowledge of the project's likelihood of failure.

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[8] It is well-established that summary judgment is inappropriate to decide questions of scienter, knowledge and intent. *See, e.g., Poller v. Columbia Broadcasting System*, 368 U.S. 464, 473, 82 S.Ct. 486, 491, 7 L.Ed.2d 458 (1962) ("summary procedures should be used sparingly in complex antitrust litigation where motive and intent play leading roles, the proof is largely in the hands of the alleged conspirators, and hostile witnesses thicken the plot").

First, the defendant Rice's previous attempts to acquire financing were unsuccessful because the project was financially infeasible in view of the adverse conditions in the bond market. This fact was known to the other defendants. Second, the defendants ignored the warnings of the original underwriter and feasibility consultant that the project would not generate sufficient revenues to repay the bonds at marketable interest rates. Instead, they agreed to modify the project by increasing both apartment unit prices and bond interest rates to make the project appear feasible although they knew that the changes would render the apartments too expensive to be sold in the relevant geographic market. Third, the defendants allegedly knew that Rice's sham pre-sale agreements made the project appear feasible. Fourth, the defendants were aware that long delays in construction of the facility "burned" the sales territory irreparably damaging consumers' interest in purchasing Mount Royal units. Finally, the defendants were able to market the bonds only because they failed to expose the project's inauspicious background which would have seriously undermined the conclusion in the Official Statement that the project was feasible.

The district court reviewed the evidence presented and concluded that there was no evidence from which a jury could reasonably infer a scheme to bring securities into the market which were not entitled to be marketed. In affirming the district court, the majority concludes that the plaintiffs provided only two categories of evidence to satisfy their burden of proof under *Shores*: (1) the fact that past financing attempts failed; and (2) the unsuccessful pre-marketing program and lack of legitimate pre-sales. The majority concludes that the former is irrelevant and that the latter does not create an inference that the bonds were unmarketable. The majority, however, simply ignores the permissible alternative inferences that a court must afford this evidence on summary judgment. Viewed in a light most favorable to the plaintiffs, the plaintiffs' evidence collectively supports the plaintiffs' contention that the bonds were unmarketable due to the defendants' fraudulent scheme.

A. Past Financing Attempts Failed

> [W]e have been plagued all year with the most unfavorable bond market in recent years which, unfortunately, has continued to deteriorate over the last several weeks to the point where the investor interest in non-rated, long term tax-exempt bonds is virtually nonexistent.[9]

Rice made a number of attempts to acquire traditional financing for the Mount Royal Towers project as a for-profit or non-profit venture each of which ended in failure. The plaintiffs claim that Rice and the other defendans knew of these previous failures to attain sufficient financing yet continued to promote the ill-fated project. The plaintiffs assert that the defendants contributed to the project's infeasibility by doubling occupancy fees despite cautions from the previous underwriter and feasibility consultant that existing fees were as high as the market would bear.

The majority concludes that the new project was so dissimilar to the previous projects that the opinions of the underwriter and experts regarding the previous projects' feasibility are irrelevant in establishing the plaintiffs' burden of proof under a *Shores* cause of action. Maj. op. at 730. The majority states that "the caution against increasing the occupancy fee, which was in the context of the previous deal, could not logically apply to the feasibility of the deal under the new pricing structure." *Id.*

The illogic, however, is the majority's holding that the restructured project made the residential units *more* financially attractive and that past failures to obtain financing, therefore, provided no basis for inferring that the defendants knew that the Mount Royal Towers project would fail. The majority's reasoning is structured as follows:

> (1) Assume Project 1 is infeasbile;
> (2) Project 2 differs from Project 1 because Project 2 has a more lenient refund policy;

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[9]Kelley Deposition, Exh. 109. Thomas Kelley, an underwriter with Henderson, Few who worked on the Mount Royal project, was explaining why Henderson, Few made the decision not to market the Mount Royal Towers bond issue only one month prior to Rice's decision to go forward with the project.

(3) Project 2's more lenient refund policy makes Project 2 similar to ownership versus renting;
(4) Because of its more lenient refund policy and similarity to ownership, Project 2 is more financially attractive to prospective residents than Project 1; Therefore, evidence that Project 1 is infeasible is irrelevant on the issue of whether Project 2 is infeasible because Project 2 differs from and is preferable to Project 1.

Plaintiffs present the alternative and factually supportable theory that Project 2's differences make it *less* desirable than Project 1. Therefore, because Project 1 is infeasible, Project 2, which is less desirable, is also infeasible.

The majority's syllogism is fatally flawed for a number of reasons. First, the two projects had significant differences such as the amount of occupancy fees, the refund policy (which subordinated refunds to bondholders), the number of residential units, the dollar amount and interest rate of the bond issues, and the contingent nature of the defendants' fees.[10] *All* of these differences are relevant in determining whether the restructured project was financially feasible. The majority, however, focuses solely on one of these differences (the refund policy) rather than analyzing the collective impact of all the differences. Further, the majority's prepaid rent versus ownership analogy masks the simple fact that the second plan required significantly higher up-front and monthly payments and that residents were essentially investing in the capitalization of the Mount Royal project.[11]

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[10]Unlike the previous projects, Rice and other defendants had an undisclosed financial interest in marketing the bonds. Rice stood to lose a substantial personal investment in the project if the bonds were not issued because he had invested almost $500,000 of his own money (he ultimately received $667,000 from the proceeds of the project). Further, the other defendants were on contingency contracts from which they would receive payment for their services only if the bonds were ultimately marketed. The defendants also increased so-called "soft costs" and other expenses payable to themselves under the new bond issue. *See* Sirmans, *Real Estate Finance* 316 (1985) (soft costs include legal, architectural, and other development fees). The majority makes no mention of these facts.

[11]It must be remembered that there was no stock in the corporation. The only source of funding was the sale of bonds.

Next, the majority reaches the unwarranted and erroneous conclusion that the restructured project was more "financially attractive" because of the second project's assertedly more lenient refund policy and similarity to ownership. There is no basis, however, for the conclusion that this refund policy is "lenient" nor is there support in the record for a finding that prospective residents preferred ownership over renting. Instead, the record and simple economic sense establish that the refund policy actually increased residents' risk of financial loss and adversely affected the feasibility of the project's marketing plan. The majority's conclusions regarding the economic effects of the second project's refund policy are simply unsupported by either economic logic or the evidence in the record.

Finally, the majority completes its unrealistic syllogism with the conclusion that because the second project is preferable to the first project (a false assumption), evidence of prior financing failures are irrelevant in determining whether the second project is feasible. In short, the majority's premise (that the projects are dissimilar) does not support its conclusion (that the prior project's financial infeasibility is irrelevant). A more reasonable conclusion is that the differences between the old and new projects actually *favor* the plaintiffs' theory that the second project was infeasible and the bonds unmarketable.[12] Rather than permitting the trier of fact to decide which inferences are to be drawn from the projects' differences, the majority simply presents its own subjective and erroneous view that the restructured project was preferable to the old one. These types of inferences are for the trier of fact, not a court on summary judgment.

1. Refund Policy

The majority is correct in stating that there were differences in the marketing and occupancy fee structures between the first Mount Royal project and the one that ultimately

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[12]The plaintiffs' theory is that the first project was financially infeasible and the bonds were unmarketable, because the restructured program decreased the project's financial feasibility, the issued bonds were also unmarketable.

failed. The majority, however, focuses on only *one* different factor: the refundability of the occupancy fees differed under the two plans. The majority then makes an erroneous leap in its analysis by concluding that because there was a difference in occupancy fee refund policy, none of the evidence of the project's past failures is relevant to prove unmarketability. A closer look at the facts reveals a different picture.

The original plan allowed a partial refund of occupancy fees based upon the length of time a resident occupied a unit. The amount of refund equaled the occupancy fee less an application fee of $1,500 less 2 percent per month for up to four years of occupancy. Thus, a resident who paid $27,880 for a one bedroom residential unit and who later decides to terminate the occupancy contract after two years would receive a $12,956 refund. After four years of occupation, none of the occupancy fee was refundable.

The plan developed by defendants provided that a prospective resident purchase a "nontransferable" right to lifetime occupancy in the facility. If the resident dies, decides to leave, or is transferred to the project's health care unit, the occupancy contract terminates and the company can enter into a contract with a new resident. The prior resident (or his estate) would then receive an amount equal to the original occupancy fee *paid* or the amount of the initial occupancy fee received by the company from the new resident, *whichever is less.* The refund, however, is given only after the prior resident dies or vacates the entire project (both residential and health care units). More importantly, residents have no right to a refund if the Mount Royal Towers project goes into default (a factor not incorporated into the defendant Laventhol & Horvath's feasibility study). Official Statement, at 35. Residents' rights to refunds are therefore contingent on a number of factors which hinge on the success of the project itself.

For example, under the second plan a prospective resident who pays a $72,500 occupancy fee for a one-bedroom unit and who later decides to terminate the occupancy contract after two years *might* receive a refund if a number of

conditions are met. First, the Mount Royal Towers bond issue must not be in default (because purchaser stake subject to the bond indebtedness). The resident's entire occupancy fee would be non-refundable resulting in a $72,500 loss if the project were foreclosed. Second, assuming the project remained financially viable, the resident would receive her entire occupancy fee only if a new resident pays an occupancy fee equal to or greater than the original resident's occupancy fee. Thus, if the market rate for a one-bedroom unit falls to $50,000, the former resident incurs a loss of $22,500 on her unit (assuming a new resident pays $50,000 for the use of the unit).

2. Increased Occupancy Fees

The majority reaches the startling conclusion that the new refund policy under the second plan makes "the package more financially attractive" obviously warranting "a substantial increase in occupancy fees." Maj. op. at 730. This conclusion, however, is based on a deficient analysis of the restructured project and the improper application of basic economic principles. A brief review of the occupancy fee rate structures, the feasibility study assumptions, and pre-sale marketing data demonstrates the infirmity of the majority's position.

The Mount Royal Towers project originally was based on the schedule of occupancy fees and monthly service and maintenance fees contained in Table 1. These are the fees upon which the Peat, Marwick & Mitchell feasibility study relied.

Table 1

Type of Unit	Initial Average Occupancy Fee	Average Monthly Service Fee	Number of Units
Studio	$21,700	$290	78
One-bedroom	27,880	390	117
Two-bedroom	43,300	490	45
Penthouse	51,800	590	16
			250

Additional Fee for Double Occupancy = $2,500
Additional Monthly Fee for Double Occupancy = $175
(does not include studio)

Peat, Marwick, Mitchell & Co., Feasibility Study, Nov. 16, 1979, at A-40.[13]

The proposed occupancy and monthly service and maintenance fees increased substantially following the decision to increase the bonds' interest rates (Table 2).

Table 2
Initial Occupancy Fees

Type of Unit	Occupancy Fee	Monthly Service Fee		Number of Units
		Single	Double	
Studio	$ 54,900	$ 631	—	18
One-bedroom	72,500	755	$1087	90
Two-bedroom				
900 sq. ft.	107,500	940	1272	45
1000 sq. ft.	119,500	1010	1342	9
1200 sq. ft.	148,500	1210	1542	18
Three-bedroom	178,000	1535	1867	9
Penthouse				
1050 sq. ft.	126,600	1055	1387	10
1400 sq. ft.	172,400	1515	1847	6
				205

Source: Official Statement, at 16; Laventhol & Horvath, Feasibility Study, at 53.

[13]The Peat, Marwick feasibility study included specific analysis of the demographic characteristics of the Jefferson County, Alabama market (which includes Birmingham). The study considered such factors as population trends in the county including age, race and sex composition, financial status of the elderly population in the Birmingham area, income distribution in the county, mortality data, economic

The Peat, Marwick study assumed a 63% occupancy rate for five months in 1981 increasing to 90% in subsequent years.[14] The Laventhol & Horvath feasibility study, which relied upon the new fee schedule, continued to adhere to occupancy rate assumption that were similar, if not more favorable, than those contained in the Peat, Marwick feasbility study. The Laventhol & Horvath study simply stated "[t]he occupancy rate for the Residential Living Units is projected to be 98 percent after the first full year of operation and 42 percent during the first year of operation." Laventhol & Hovarth, Feasibility Study, at 45. The study provided no market study based information for these assumptions.[15]

First, the majority erroneous concludes that the new refund policy is more lenient (i.e., favorable towards residents). The majority simply neglects the fact that the new refund policy sharply limits a resident's right to receive a refund based on the project's continued financial stability and the availability of prospective residents willing to pay the higher occupancy fee. Prospective residents would find these limitations undesirable thus making the package *less* financially attractive. Under the majority's logic, for instance, prospective residents would be willing to pay $72,500 (representing a $44,620 premium over the $27,880 original occupancy fee) for a one bedroom unit solely for the opportunity to receive a refund which is wholly dependent upon the project's financial success. This result makes no economic sense.

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activity data for the county, and the experience of other retirement centers across the country. *See generally*, Rabinowitz, *Land Investment and the Pre-development Process*, 64-89 (1988) (identifying various demographic and income-related factors relevant in determining feasibility).

[14]The estimates were based on "historical utilization figures for retirement centers nationwide and for local Jefferson County nursing homes." Peat, Marwick, Feasibility Study, at A-38.

[15]The Laventhol & Horvath occupancy rate assumptions would require projected sales to elderly individuals at the new higher prices to have occurred in a short period of time following the project's construction. Because it was uncertain whether there would be sufficient sales under the older, lower prices, it became even more suspect to assume that the occupancy rate would remain basically the same under the higher fees.

Second, the majority's conclusion that a more lenient refund policy "obviously warrants" a "substantial increase in occupancy fees" is insupportable under any economic theory or the record in this case. A more lenient refund policy might have the effect of marginally increasing the demand for Mount Royal residential units. Counterbalancing this possible increased demand, however, are the strict limitations placed on the availability of refunds (i.e., subordinated to bondholders and refundable only from a new resident's occupancy fee). These limitations would have the effect of reducing the market demand for residential units. The net effect on the demand due to the new limited refund policy might be either to raise or lower the market price for the residential units.[16] An unfounded conclusion, however, is that prospective residents would find a "substantial increase in occupancy fees" "obviously warranted." In fact, the record indicates that rather than warranting a doubling of occupancy fees, the demand for the Mount Royal units declined under the restructured deal.[17] An alternative and more reasonable conclusion is that the new refund policy and the higher occupancy fees made the residential units less desirable because of their higher price and higher risk of loss.

The majority also postulates that the original occupancy fee structure is analogous to a form of rent and that the

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[16]The demand for Mount Royal Towers residential units was uncertain because the continuing care facility was a relatively new concept and had a number of competing facilities located in the surrounding geographic area. The competing facilities included one continuing care facility (Kirkwood-by-the-River) and nine nursing homes. Laventhol & Horvath, Feasibility Study, at 40-41. The Kirkwood facility had 80 residential units. Its nonrefundable entrance fees ranged from $12,000-$40,000 and its monthly maintenance fees from $253-$731. Rice considered Kirkwood only "secondarily competitive" because of its location and facilities offered. *Id.* at 40.

[17]The pre-marketing plan for the first project was much more successful than the pre-marketing plans for the second. During 1980, Rice presold more than 130 (63%) of the 205 units. This number, however, declined to 107 (52%) by September, 1980, and dwindled to zero by December, 1980, allegedly due to the long delays in constructing the facility and obtaining financing. In contrast, after adopting the new refund policy and increasing occupancy fees only 33 of the 205 units (17%) were presold by April 1, 1981. Two months later, 47 units (24%) had been presold. Rice then reduced the required deposit from $1,000 to zero and acquired the remaining number of "agreements" to pass the 50% threshold of 103 units.

second is analogous to an ownership interest in the unit. The majority states that "the occupancy fee in the original version was in the nature of a lump sum prepayment of rent for the right to live there until death." *Id.* In contrast, the "occupancy fee under the final version was more in the nature of a purchase price for a fee simple interest" subject to various conditions. *Id.* Assuming the majority is correct in its characterizations of the occupancy fees, a brief example illustrates that the majority's distinction favors the plaintiffs' claim that the second project was infeasible.

Under the first plan, a resident who purchases a one-bedroom unit for $27,880 and lives in the unit four years effectively pays $6,970 a year in "rent."[18] Of course, the longer the resident stays in the unit, the lower the average yearly "rent" will be.[19] Under the restructured plan, a resident who pays the $72,500 occupancy fee for a one-bedroom unit and lives in the unit four years pays no "rent" and may get the entire $72,500 refunded.[20] However, the resident foregoes interest on the $72,500 fee for the four years. Assuming an interest rate of 10%, the resident could have earned $7,250 interest per year.[21] This foregone interest income constitutes a form of "rent" similar to that the majority identifies under the first plan. In addition to this foregone interest income, the resident pays significantly higher monthly maintenance fees under the restructured plan. *See* Tables 1 & 2. Finally, the resident risks losing all or part of the $72,500 occupancy fee should the project fail or the number of prospective purchasers dwindle.

Under the second plan, it appears that prospective residents were essentially being asked to become Mount Royal investors by providing large interest-free loans that were subordinate to the rights of the bondholders. In fact, the

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[18]This figure is calculated by dividing $27,880 by 4.

[19]After ten years, for example, the average "rent" attributable to the occupancy fee would be $2,788 (i.e., $27,880/10).

[20]Assuming the Mount Royal Towers project does not default and the availability of a prospective resident willing and able to purchase the open unit.

[21]A 10% interest rate is conservative given that the prime rate peaked at about 21% during the early 1980s when the Mount Royal Towers project was being promoted.

initial residents were permitted to pay occupancy fees with any combination of cash or short term Mount Royal bonds. Official Statement at 15. Thus, the expected return on their investment came, in part, from their right to reside at Mount Royal Towers without paying monthly rent (although they paid higher maintenance fees). The substantial part of their return, however, was based on a gamble that the project would flourish and that upon the termination of their occupancy agreements the project would not be in default and a queue of prospective (and affluent) residents existed. The restructured residency agreement, therefore, transformed the former relatively risk-free "rental" agreement into a riskier capital investment in the project. This transformation required the residents to shoulder an increased risk of loss (of a significantly higher investment) and presumably would make residency at Mount Royal Towers less desirable and the project therefore less feasible. Residents who balked at "renting" would likely reject "ownership" particularly when they could possibly lose their entire "ownership" investment.

Yet the majority totally ignores the impact the restructured deal would have on the units', and thus the project's, financial feasibility. Rather than rendering irrelevant the evidentiary significance that previous financing attempts had failed, the differences between the projects such as the refundability of occupancy fees increases the evidentiary significance of the previous failures. Rice's struggle to obtain financing, conventional or otherwise, relates directly to the marketability of the bonds and his knowledge of the project's anticipated success.

Further, the majority neglects the fact that the first project anticipated revenues from a *250* unit facility to pay off an $18,755,000 bond issue at 9½% interest rate; the second project anticipated revenues from a *205* unit facility to pay off a $29,950,000 bond issue at interest rates between 15% and 17%. *The second project, therefore, would have to generate more revenue from fewer units to pay off higher interest debt on a larger bond issue.* The restructured deal was also formed at a time when prospective residents could not sell their homes

because of the escalating mortgage interest rates. It requires only a meager understanding of economic principles to reasonably conclude that these differences in the restructured deal adversely affected the project's feasibility and the bonds' marketability. Because the initial bond issue was unmarketable, a permissible inference is that the restructured bond issue adversely affected the project's financial feasibility and, thus, was also unmarketable.

In summary, these differences, rather than supporting the assertion that evidence of prior failures is irrelevant, directly support the plaintiffs' theory that the ill-fated project was infeasible and that the defendants knew it. The majority's "apples and oranges" approach to determining marketability is simple untenable and places an unjustified evidentiary burden on the plaintiffs by excluding the precise evidence necessary to support a *Shores* cause of action.

B. Number of Pre-Sales Fraudulently Inflated

> That a lie which is half a truth is ever the blackest of lies, That a lie which is all a lie may be met and fought with outright, But a lie which is part a truth is a harder matter to fight.[22]

The plaintiffs allege that Rice fraudulently inflated the number of pre-sale agreements to make the project appear financially feasible. In particular, they claim he eliminated the deposit requirement as a last ditch attempt to boost the percentage of "pre-sales" and his friends, employees, and family applied for units to increase the "pre-sale" level. The defendants' claim that the Official Statement fully disclosed that many of the applications were with reduced or no deposits.[23] The Official Statement, however, only offers part of the truth in its disclosure of the number of "pre-sales."

The Official Statement disclosed that the project had 103 residency applications which accounted for 50.2% of the 205 units. Most prospective residents were required to complete

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[22]Tennyson, The Grandmother, stanza (1864)

[23]The Official Statement does not use the term pre-sales but instead refers to residents' "applications for reservations."

an application form and submit a $1,000 deposit.[24] Fifteen of the applicants, however, who had previously submitted $100 deposits were not required to increase their deposits. Further, "thirty-three other persons were not required to make any deposit with their application." Official Statement, at 15. Total application fees received amounted to $63,250. *Id.* at iii.

What the Official Statement failed to state was that most of the applications which required no deposits resulted because Rice dropped the deposit requirement to zero in order to meet the 50% level. Forty-eight applications without deposits were ultimately accepted and all forty-eight withdrew shortly after the bonds issued. Thus, the plaintiffs claim the declining deposit requirement indicates a desperate but successful attempt to reach the minimum 50% threshold necessary to make the bonds appear marketable. The fact Rice's friends, relatives, and employees submitted applications buttresses the plaintiffs' claim that Rice and the other defendants knew that the 50% threshold would make or break the deal.

The majority misses the mark in concluding that the marketing program's failure to attain 50% legitimate pre-sales does not support an inference of unmarketability. The majority claims that the plaintiffs' evidence establishing a 50% threshold only provides "satisfactory evidence of the feasibility of the project." At 731 n. 13. The basis for the majority's conclusion is its own interpretation of the deposition testimony of Thomas Kelley, the underwriter with Henderson, Few, who worked on the Mount Royal project.

Kelley stated that a viable project required a substantial number of legitimate pre-sale commitments. Kelley Deposition, at 85. A legitimate pre-sale commitment would require the potential buyer to pay a forfeitable cash deposit. Lack of such a deposit "would not be worth very much" and would be "useless as a way of evidencing the agreement to purchase" a unit. *Id.* at 88-89. Kelley also explained that issuers rely on

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[24]The Official Statement is somewhat disingenuous in stating "[u]nder current arrangements, persons desiring to become residents" must submit an application "together with a $1,000 deposit" when in fact the deposit requirement had been totally waived. Official Statement, at 15.

the financial feasibility consultant who in turn relies upon the existence of pre-sale agreements and deposits as evidence of a project's marketability. He concluded that a 50% pre-sale level and about $100,000 in deposits are a *basic requirement* for underwriting this bond issue. *Id.* at 92, 146. He testified that he had never been associated with a bond issue which had legitimate pre-sales less than 50%. *Id.* at 192-94.

Thus, Kelley's testimony establishes that the 50% level was the dividing line between marketable and unmarketable bonds. This evidence also establishes that a crucial step in determining the project's feasibility is the number of legitimate pre-sale agreements and the dollar amount of forfeitable pre-sale deposits. These two factors provide the foundation upon which the feasibility of the entire project rests. The underwriting process relies heavily upon the investigations and conclusions of the financial feasibility consultants. Thus, financial projections built upon inaccurate or fraudulent measures of pre-sale commitments crumble like a house of cards.

The majority states that the plaintiffs presented no other evidence of unmarketability (other than the unsuccessful marketing program) and that the Laventhol & Horvath feasibility study contains "substantial evidence that the sale of the units was feasible and that the bonds were marketable." At 731 n. 14. The majority's reliance on the Laventhol & Horvath feasibility study as evidence of the project's marketability is curious because the feasibility study directly relies upon the pre-sale data Rice provided as evidence of the project's feasibility. The feasibility study also concluded that the project would break-even (i.e., be feasible) only at an 88-90% occupancy rate — a far cry from the percentage of legitimate pre-sales established prior to the bonds' issuance.

Further, because Rice provided the information regarding the number and amount of pre-sale agreements upon which the feasibility consultants relied in making projections, he was in a position to control the project's apparent feasibility. For example, Peat, Marwick stated in its earlier feasibility study that its "projections are based on the assumptions by the Developer of Mount Royal Towers concerning future

events and circumstances." Peat, Marwick & Mitchell, Feasibility Study, at A-3. Rice could therefore have provided false information that ultimately forms the basis for a favorable feasibility study upon which all other underwriting participants rely. The record, therefore, simply does not support the majority's conclusion that the unsuccessful marketing program does not support an inference of unmarketability.

The majority concedes that the marketing program was not successful in obtaining 50% legitimate pre-sales with deposits but states that the plaintiffs would "have to prove that the pre-offering marketing program sufficiently predicted the failure of the project so as to render the bonds unmarketable at any price." A thorough review of the record establishes that the plaintiffs have met their burden.

First, defendant Laventhol & Horvath's feasibility study specifically states that:

> As of July 8, 1981 approximately 32 percent of the residential units had been reserved; *the underwriter intends that the series 1981 Bonds will be issued when approximately 50 percent of the residential units have been reserved.*

Laventhol & Horvath, Feasibility Study, at 45. (emphasis added). The feasibility study therefore indicates that the 50% pre-sale threshold separated marketable from unmarketable bonds. In addition, Kelley's deposition testimony repeatedly affirms that 50% legitimate pre-sales were a minimum marketability standard. It is difficult to imagine more probative evidence of a bond issue's unmarketability than statements by a project's developer, underwriter, or feasibility consultant that 50% legitimate pre-sales were a marketability litmus test.

Further, the majority's statement that the bonds "sold" despite disclosure of "most of the facts" about the pre-marketing program is circular. Had *all* the facts been disclosed, the project's already precarious financial outlook would be further weakened and the bonds may not have issued. In particular, the fact that the applications without deposits occurred shortly before the bond issued closed provides particularly persuasive evidence that the defen-

dants' attempt to reach the 50% marketability threshold raises a jury issue of fraud.

The majority distinguishes this case from *Shores* because the misrepresentations in *Shores* "went to the concealment of existing factors vital to the viability of the project." At 731. In contrast, the alleged fraud here "centers on projections of an uncertain future occurrence, i.e., the sale of apartments." *Id.* The majority's distinction, however, simply does not apply in this case because the number of legitimate pre-sales is an existing fact upon which the feasibility of the entire project hinged. Kelley's deposition testimony established the fact that issuers and financial feasibility consultants rely upon the existence of legitimate pre-sale agreements and deposits as evidence of a project's marketability. Thus, the number of legitimate pre-sales is certainly "vital to the viability of the project" in addition to being current measures of the market demand for the units.

For all these reasons, the plaintiffs' assertion that Rice engaged in sham pre-sale agreements to make the project appear feasible and the bonds appear marketable creates a genuine issue of fact under *Shores*.

CONCLUSION

The majority commences its wayward path by failing to follow the appropriate standard of review for fraud cases. To determine the truth in this case, it is necessary to look into the defendants' minds to ascertain whether they honestly believed the Mount Royal Towers units could be sold in sufficient number to support the issuance of the bonds or whether they were counting on a miracle. The plaintiffs' documentary and deposition evidence submitted in response to the defendants' motion for summary judgment creates a genuine issue of fact as to whether the apartment units, and thus the bonds, were marketable.

The defendants knew of the past cancellations of a similar project where the bond issue was $10,500,000 less than the final project, the occupancy fees and maintenance fees were fifty percent less, and the number of "presales" were greater and accompanied with larger deposits. This evidence,

coupled with evidence of fraud in the "presales" the defendant Rice obtained, evidence of financial motives to market the unmarketable bonds, and finally evidence of the failure of the project, suffice to make a jury issue of whether the defendants knew the bonds were unmarketable. Thus, I respectfully dissent.